SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

INDEX.

JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., NOVEMBER 9, 1943.

—8853

[fol. 1]

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 2556

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

vs.

THE SECURITY FLOUR MILLS COMPANY, Respondent

No. 2589

THE SECURITY FLOUR MILLS COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DESIGNATION OF PORTION OF THE RECORD TO BE PRINTED, No. 2556—Filed May 2, 1942

Comes Now the petitioner on review herein, and complying with the rules of this Court, pertaining to the designation of the portion of the record to be printed, states that he relies upon the entire record certified by the Clerk of the United States Board of Tax Appeals to this Court, and directs that said record so certified be printed as the record on review.

Respectfully submitted, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Statement of Service

A copy of this designation of portion of the record to be printed was mailed to Robert C. Foulston, Esq., Wichita, Kansas, attorney for respondent on review this date, April 30, 1942.

Chas. E. Lowery, Special Attorney, Bureau of Internal Revenue.

[File endorsement omitted.]

[fol. 2] IN UNITED STATES CIRCUIT COURT OF APPEALS

STATEMENT OF POINTS RELIED UPON BY PETITIONER, CASE No. 2589—Filed July 22, 1942

Comes now the petitioner on review herein, and makes this concise statement of points upon which it intends to rely upon review herein:

(1) The United States Board of Tax Appeals erred in affirming the determination of the Commissioner of Internal Revenue of a deficiency in the 1935 income tax return of appellant.

(2) The decision and judgment of the United States Board of Tax Appeals is contrary to law and is contrary to and is not supported by either the undisputed evidence herein or the findings of fact of said United States Board of Tax Appeals.

(3) Under the undisputed facts herein and under the United States Board of Tax Appeals' own findings of fact, the said Board erred in holding that the petitioner received a refund of processing taxes and in including such refund in the income of the petitioner for the fiscal year ended December 31, 1935.

(4) The United States Board of Tax Appeals erred in holding or basically assuming that the burden was upon petitioner affirmatively to establish that petitioner did not receive a refund of processing taxes paid during the year 1935.

(5) The United States Board of Tax Appeals erred in not giving final, controlling, and conclusive weight to the closing agreement (petitioner's Exhibit "1") entered into between petitioner and respondent.

(6) The United States Board of Tax Appeals found that the petitioner's Title VII refund was $15,928.82 and interest thereon in the amount of $4,546.06, or a total of $20,474.88, which finding was unsupported by any evidence, and the Board erred in so finding.

(7) The Board erred as a matter of law in finding the processing tax refund was in the total amount of $20,474.88, and that the petitioner's unjust enrichment tax under Title III of the Revenue Act of 1936 was $36,880.21.

[fol. 3] (8) The Board's finding that the petitioner's Title III *injust* enrichment tax of $36,880.21 was unsupported by any evidence, and the verdict erred in so finding.

(9) The Board in finding that the petitioner received a refund of $20,474.88, including interest, disregarded all the positive and affirmative evidence submitted by petitioner with respect to the payment of its Title III tax.

(10) The Board erred in holding and deciding that an alleged refund of $20,474.88 should be included in the taxable income of petitioner for the year ending December 31, 1935.

(11) The Board erred in holding that there is a deficiency in income tax of $496.73 due from the petitioner for the calendar year 1935.

Carl T. Smith, Attorney for Petitioner on Review.

IN UNITED STATES CIRCUIT COURT OF APPEALS

DESIGNATION OF PORTION OF RECORD TO BE PRINTED, CASE No. 2589—Filed July 22, 1942

Comes now the petitioner on review herein, and complying with the rules of this Court pertaining to the designation of the portion of the record to be printed, states that it relies upon the entire record certified by the clerk of the United States Board of Tax Appeals, to this Court, and directs that said record so certified be printed as the record on review, together with the petitioner's statement of points relied upon in this appeal, and any and all orders enlarging the time for the docketing of the within appeal, this designation, and petitioner's proof of service upon counsel for respondent of this designation and of said statement of points relied upon in this appeal.

Respectfully submitted, Carl T. Smith, Attorney for Petitioner on Review.

[File endorsement omitted.]

[fol. 4] In United States Circuit Court of Appeals

Order Extending Time for Docketing Cause, Case No. 2589

Forty-fourth Day, March Term, Saturday, July 18th, A. D. 1942. Before Honorable Orie L. Phillips, Circuit Judge, and Honorable J. Foster Symes, District Judge.

This cause came on to be heard on the motion of petitioner for leave to docket the cause and file the transcript of the record herein out of time and was submitted to the court.

On consideration whereof, it is now here ordered by the court that said motion be and the same is hereby granted and that the cause may be docketed and the transcript of the record filed instanter, which is accordingly done.

In United States Circuit Court of Appeals

Stipulation as to One Record, Cases Nos. 2556 and 2589—Filed September 28, 1942

The undersigned counsel for Guy T. Helvering, Commissioner of Internal Revenue, Petitioner on Review in case No. 2556, and Respondent on Review in case No. 2589, by his respective counsel hereunto signing, and The Security Flour Mills Company, Respondent in case No. 2556, and Petitioner in case No. 2589, desiring to avoid multiplicity of records on appeal herein, do hereby stipulate and agree that there be one record on appeal for the respective undersigned appellants, and that the argument of these appeals of the undersigned appellants be heard by this Court on the said single record.

It is further stipulated by the parties hereto that the cost of printing said record shall be borne and paid for by the parties hereto in equal proportions. That is to say, that The Security Flour Mills Company shall pay one-half of said cost of printing said record and one-half thereof shall be charged to the Department of Justice.

Samuel O. Clark, Jr., Assistant Attorney General, Department of Justice, Washington, D. C., for the Commissioner of Internal Revenue.

Robert C. Foulston, of Wichita, Kansas, Counsel for The Security Flour Mills Company.

[File endorsement omitted.]

[fol. 4a] [Caption omitted]

[fol. 5] BEFORE UNITED STATES BOARD OF TAX APPEALS

THE SECURITY FLOUR MILLS COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 90137

Appearances—For Taxpayer: Vincent A. Smith, C. P. A., Wm. H. Moberly, C. P. A., Robert C. Foulston, Esq., Harry E. Lansford, Esq., Parry Barnes, Esq.: For Commissioner: R. P. Hertzog, Esq., J. Y. Porter, Esq., W. V. Crosswhite, Esq.

DOCKET ENTRIES

1937

Aug. 9. Petition received and filed. Taxpayer notified. Fee paid.
Aug. 9. Copy of petition served on General Counsel.
Aug. 31. Answer filed by General Counsel.
Sept. 3. Copy of answer served on taxpayer.
Sept. 20. Motion for circuit hearing at Wichita, Kansas, of Kansas City, Mo., filed by taxpayer. 9/22/37 granted

1939

Sept. 22. Hearing set Nov. 27, 1939, at Kansas City, Mo.
Oct. 13. Motion for leave to file amended answer, amended answer lodged, filed by General Counsel.
Oct. 16. Motion for leave to file amended answer granted.
Nov. 6. Notice of appearance of Robert C. Foulston, Harry E. Lansford, Vincent A. Smith and Parry Barnes as counsel filed.
Nov. 6. Reply to amended answer filed by taxpayer.
Nov. 6. Motion for leave to file amended petition filed by petitioner.
Nov. 6. Amended petition lodged.
Nov. 6. Copy of reply served on General Counsel.
Nov. 10. Hearing set Nov. 27, 1939, on motion in Kansas City, Mo., 11/10/39 copy served.

[fol. 6]

1939

Nov. 28. Hearing had before Mr. Arnold on merits. Submitted. Continued to 11/29/39 for the purpose of receiving reply. Amended petition. Answer to amended and supplemental petition filed. Copy served. Stipulation as to facts and reply to amended petition filed. Copy served. Petitioner's brief due 1/15/40—respondent's 2/13/40—reply 2/28/40.

Dec. 14. Transcript of hearing of 11/28/39 filed.

1940

Jan. 9. Motion for extension to Feb. 12, 1940, to file brief filed by taxpayer. 1/10/40 granted.

Feb. 6. Brief filed by taxpayer. 2/6/40 copy served.

Mar. 13. Brief filed by General Counsel.

Apr. 8. Motion for extension of three days to file reply brief filed by taxpayer. Granted and extended to 4/13/40.

Apr. 13. Reply brief filed by taxpayer. 4/15/40 copy served.

Apr. 15. Copy of motion served on General Counsel.

Aug. 30. Order that proceeding be restored to the Washington calendar of 9/18/40 at which time the parties may submit further testimony showing the manner in which the proceeding taxes were deducted for 1935, unless prior to that date the facts are presented in the form of a stipulation duly signed by respective parties entered.

Sept. 12. Motion that Board enter an order extending the time when this proceeding shall be restored to the Washington calendar and that such date of restoration be fixed as October 2, 1940, instead of September 18, 1940, filed by General Counsel. Granted.

Oct. 1. Stipulation of facts filed.

Oct. 2. Hearing had before Mr. Arundell on the merits. Submitted heretofore. For further testimony unless stipulation of facts have been filed. Stipulation of facts filed Oct. 1, 1940.

1941

Nov. 12. Findings of fact and opinion rendered, Mellott. Decision will be entered under Rule 50. 11/12/41 copy served.

[fol. 7]

Dec. 24. Agreed computation of deficiency filed.
Dec. 29. Decision entered, Mellott, Div. 11.

1942

Feb. 11. Petition for review by U. S. Circuit Court of Appeals, 10th Circuit with assignments of error filed by taxpayer.
Feb. 12. Proof of service filed.
Mar. 26. Petition for review by U. S. Circuit Court of Appeals, 10th Circuit filed by General Counsel.
Apr. 2. Proof of service filed.
Apr. 13. Proof of service filed.
Apr. 17. Statement of points filed by General Counsel with statement of service by mail thereon.
Apr. 17. Designation of record filed by General Counsel with statement of service by mail thereon.

BEFORE UNITED STATES BOARD OF TAX APPEALS

AMENDED AND SUPPLEMENTAL PETITION—Filed November 28, 1939

The above petitioner, The Security Flour Mills Company, hereby files this, its amended and supplemental petition in the above-matter, for redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:E:3 JTA-90D), dated June 21, 1937, and as the basis for such proceedings, alleges as follows:

(1) The petitioner is a corporation, organized and existing under and by virtue of the laws of Kansas, with principal office at Abilene, Kansas.

(2) The notice of deficiency (copy of which is attached and marked Exhibit "A") was mailed to the petitioner on June 21, 1937.

(3) The taxes in controversy are income and excess profits taxes for the calendar year ended December 31, 1935,

in the amount of Fourteen Thousand Seven Hundred Two and 48/100 Dollars ($14,702.48) covering income taxes and Three Thousand *Eight*-eight Hundred and 80/100 Dollars ($3,088.80) covering excess profits taxes for said year.

(4) The determination of the tax set forth in the notice of deficiency is based upon the following errors:

[fol. 8] (4-a) The Commissioner of Internal Revenue erred in disallowing as a deduction from gross income the amount of One Hundred One Thousand Seven Hundred Eighty-three and 89/00 Dollars ($101,783.89) (said amount having been ascertained since the filing of the petition herein to be the actual amount of impounded funds and accrued processing taxes due and payable as at December 31, 1935), which sum represents so-called processing taxes which were sought to be exacted from the petitioner under the terms of the Agricultural Adjustment Act during that period beginning May 1, 1935, and ended December 31, 1935, and impounded during the pendency of an injunction proceeding under the order of the District Court of the United States, for the District of Kansas, Second Division, of which sum the petitioner became possessed upon rendition of final judgment in said cause in the amount of Ninety-three Thousand Nine Hundred Seventy-four and 40/100 Dollars ($93,974.40) and taxes sought to be imposed under said Agricultural Adjustment Act for the month of December, 1935, but not paid to the Treasury of the United States because of the decision of the Supreme Court of the United States in the case of United States v. Butler, et al., 297 U. S. 1, 80 L. ed. 477, in the net sum of Seven Thousand Eight Hundred Nine and 49/100 Dollars ($7,809.49), the total of said two sums being One Hundred One Thousand Seven Hundred Eighty-three and 89/100 Dollars ($101,783.89).

That in the succeeding paragraphs of this amended and supplemental petition, more particular reference is made to the facts, circumstances and conditions relating to said items, which allegations of fact pertaining thereto are incorporated in this paragraph as a part thereof as fully as if restated herein.

(4-B) As an alternate to the facts set forth in the preceding paragraph (4-a), in event that the determination of the Commissioner of Internal Revenue relating thereto

under said paragraph are sustained by the Board of Tax Appeals, and also supplementing said paragraph (4-a) above, and without regard to what decision shall be reached by the Board of Tax Appeals, or in final decision under said paragraph, the Commissioner of Internal Revenue erred, [fol. 9] (1) in failing to allow and treat as a deduction from gross income the sum of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90), which sum was actually paid to certain vendees of the petitioner to whom the petitioner was obligated under agreements, arrangements, conditions and contracts hereinafter more specifically alleged (the exact amount of which reimbursements which said petitioner was liable to make and did make, having been determined as aforesaid, since the filing of the original petition herein), and (2) in not adjusting the gross income of the petitioner by a diminution thereof in the amount of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90) so as to reflect true income and, (3) in failing to give effect to the recognized liabilities of petitioner's to its vendees in order to properly reflect income and, (4) in failing to give due and proper effect to the requirements of Sections 41, 42 and 43 of the Revenue Act of 1934 which require the Commissioner to consider credits and deductions for the taxable year in which 'paid or accrued' or 'paid and incurred,' dependent upon the method of accounting upon the basis of which the net income is computed and in so disregarding the mandatory provisions of said Sections 41, 42 and 43 as to distort and improperly reflect petitioner's income for said period, all as more fully set forth herein.

(4-c) The Commissioner further erred in the failure to allow adjustment in the value of the inventory of flour on hand as of December 31, 1935, due to further reduction in the amount of processing taxes included in inventory as of that date, in the amount of Two Hundred Ninety-seven and 32/100 Dollars ($297.32) to which the petitioner was entitled in order to reflect income.

That the petitioner withdraws the assignment of error contained in paragraph (4-c) of its original petition relating to the disallowance of One Thousand Four Hundred Four and 8/100 Dollars ($1,404.08) for certain expenses of litigation, attorneys fees, etc.

(4-d) Petitioner further alleges that if the petitioner is allowed the deductions for processing taxes set forth in (4-a) above, and to which it may be properly entitled for [fol. 10] the year 1935, then the petitioner alleges that to the best of its knowledge and belief, it is entitled to refund of income taxes actually paid for said year and if upon final decision of the United States Board of Tax Appeals for said reason overassessment results, then the petitioner makes a claim for such overassessment and asks the Bureau to determine that this petitioner is entitled to a refund in such amount as it has been overtaxed.

(5) The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(5-a-1) The Security Flour Mills Company, petitioner herein, at all times material, conducted a flour milling business at Abilene, Kansas; said mill being located in what is known as the wheat belt of Kansas, and was in competition with a large number of other mills located in said territory. That early in the spring of 1935, certain publicity was given to some litigation instituted by various processors throughout the United States challenging the constitutionality of the Agricultural Adjustment Act. From time to time such discussion become more definite and in the month of April, 1935, various milling institutions throughout the United States instituted actions to enjoin the collection of said processing taxes. That thereafter, in the spring of 1935, various milling companies in the state of Kansas instituted actions in the United States District Court for the purpose of enjoining the collection of processing taxes. That during said period of time, the petitioner herein was issuing confirmation under what is known as a Millers National Federation Uniform Sales contract. That as a result of this discussion and the filing of suits by competitors of this petitioner, the petitioner sought advice of counsel concerning said matters, and also concerning the Millers National Federation Uniform Sales Contract. That counsel for the petitioner recommended that in order to protect the petitioner and its vendees in the event the act should be declared unconstitutional, that an action be instituted for that purpose, and also advised the petitioner that in the judgment of counsel, the Millers National Federation Uniform Sales Contract being then used by the petitioner did not relate to

or in any manner affect the rights of vendees or the peti-
[fol. 11] tioner in event the Agricultural Adjustment Act should be declared unconstitutional, but relates only to the question of administrative or other changes and the amount of the tax postdating the date of its execution prior to the shipment of flour thereunder.

That during said time, frequent inquiries were made by various vendees of the petitioner in connection with the sale and purchase of flour and mill products as to what the attitude of the petitioner would be in event injunction proceedings were effective. That there were many conditions and circumstances which made it impossible for the petitioner to make an agreement with the customers in the exact terms of dollars and cents which would be refunded to such customers, but with certain customers who had been purchasers of the petitioner for a long period of time, the officers and sales department of the petitioner advised such customers that when the matter was finally determined, that such customers would be treated fairly by the petitioner, and the attention of such vendees was called to the fact that the petitioner had been doing business with them for a long period of time and that they could depend upon fair treatment when the facts were finally known, and the ability of the petitioner with reference to making refunds could be definitely determined.

In frequent instances, the vendees, before placing orders for flour or other milled products, inquired of the petitioner as to what its attitude would be in event of the successful prosecution of such proceedings, and it became and was the established practice of this petitioner to advise such vendees that they would be treated fairly when the facts had been finally determined.

(5-a-2) That thereafter, on the 29 day of June, 1935, this petitioner, through its counsel, caused to be instituted in the District Court of the United States in and for the District of Kansas, an action entitled, "The Security Flour Mills Company, plaintiff, vs. H. D. Baker, Individually, and as Collector of Internal Revenue for the District of Kansas, defendant," being numbered in Equity No. 718-N, wherein this petitioner sought an injunction against the Collector
[fol. 12] of Internal Revenue against the collection and im-

position of the so-called processing taxes under the terms of the Agricultural Adjustment Act.

That on the 24 day of July, 1935, a temporary injunction was issued by the Judge of said Court, enjoining the collection of said tax on condition that in lieu of bond, the plaintiff would file informative returns with the Collector of Internal Revenue, and would deposit in The Fourth National Bank in Wichita, Kansas, a sum of money equal to the tax otherwise due as shown by such returns. That the bill of complaint filed in said suit, among other things, alleged:

"* * * the purchasers of flour and processed products from the plaintiff have indicated their intention to resist their contracts with this plaintiff and with other commercial mills likewise situated because of the alleged unconstitutionality of said Act, and throughout the milling industry notices have been given, and will hereafter be given in ever increasing numbers, demanding of the plaintiff and other milling institutions refunds to them of an amount equal to the assessment and so-called tax imposed upon the milling of wheat, (whether the same was passed on by the plaintiff or not) and have likewise demanded that refunds be obtained to the use and benefit of such purchasers of flour and milled products;"

That thereafter, an Amended and Supplemental Bill of Complaint was filed, which alleged among other things, the following:

"Plaintiff's customers are continually calling to plaintiff's attention the issuance of such injunctions to plaintiff's competitors, and to the fact that plaintiff's competitors are affording protection to their customers against the continued imposition of such purported processing taxes. They are demanding and will continue to demand, that plaintiff protect them against the continued imposition of such processing taxes, and are threatening to, and will, refuse to deal further with plaintiff unless it affords such protection to its own customers. Plaintiff's customers are continually threatening to deduct from plaintiff's invoices attempted estimate of the amount of the so-called process- [fol. 13] ing tax paid by plaintiff in connection with the processing of its products sold to such customers. Failure of plaintiff to withhold payment of such taxes and thereby protect and preserve the rights of its customers to have

the legality and constitutionality of such taxes determined by the Court will cause great ill will to plaintiff on the part of its customers and will result in great and irreparable loss to plaintiff, all to plaintiff's irreparable injury for which plaintiff has no adequate remedy at law. Plaintiff is unable adequately to protect its said customers by the payment of the said processing taxes because of the inadequacy of the legal remedy to secure refunds as hereinbefore set forth."

That in said action, the petitioner herein, at the inception of said litigation, recognized the demands of its customers and vendees as above stated. That the said petitioner, from time to time, deposited moneys as required by said interlocutory order in The Fourth National Bank in Wichita, Wichita, Kansas, from the effective date of said order, to-wit: May 1, 1935, until the determination of the unconstitutionality of the Agricultural Adjustment Act decided by the Supreme Court of the United States on the 6 day of January, 1936, except that said petitioner did not deposit in said bank the sum of Seven Thousand Eight Hundred Nine and 49/100 Dollars ($7,809.49), which sum was not paid to the Collector of Internal Revenue, and was withheld because of said decision. That almost immediately upon the decision by the Supreme Court of the United States, as aforesaid, certain vendees of the petitioner, or other mills likewise prosecuting said suits, filed petitions of intervention seeking to have said funds thus on deposit in The Fourth National Bank in Wichita, sequestered and administered under the order of the Court for the benefit of said vendees. That said petitioner instituted said action for the reasons appearing therein and filed a brief with the Judge of said Court, which brief contained, among others, the following statements: That during all of said period of time, and from time to time, in dealing with said vendees and customers, the petitioner advised said customers that it was unable to agree upon an exact amount which would be repaid by said petitioner, [fol. 14] but said petitioner agreed, in substance, that when the rights of the parties were determined in said litigation, the various customers to whom said promises were made would be treated fairly and that The Security Flour Mills Company would do the right and fair thing with said customers. That all of said declarations, allegations and conduct of said petitioner were consistent with its understand-

ing and agreement with certain of its customers (those with whom refunds were made as hereinafter alleged) that it would treat such customers fairly and also that it would treat such customers as well as competitive milling companies would be able to and would do. That the vendees with whom settlement was ultimately made by said petitioner acted and relied upon the understanding, agreements and course of conduct herein recited and upon the past transactions and long course of business dealings between the petitioner and said vendees that it would ultimately, when the facts were known, treat the said vendees fairly.

That on the 28 day of February, 1936, the District Court of the United States made an order making permanent the injunction in said case and ordering the payment to this petitioner of said sum of Ninety-three Thousand Nine Hundred Seventy-four and 40/100 Dollars ($93,974.40) to be returned by the said bank to said petitioner.

(5-a-3) That this petitioner, consistent with its understanding, agreement and obligations to its various vendees, received said money from said bank, and opened a new account upon its books to which said sum was credited under the title of Reserve for Processing Tax Claims, etc. That at the time of the receiving of said funds from said The Fourth National Bank in Wichita, and at all times prior thereto, this petitioner recognized its obligation to certain of its vendees, and its liability to make refunds to them when and as the proper and fair amount of such refunds could be determined. That the matter of making said adjustments were delayed by several matters beyond the control of the petitioner, but among which was the filing of separate suits by certain vendees under the mistaken idea of the liability of the petitioner under the so-called Miller's National Federation Uniform Sales Contract, and by the filing of separate suits against either the peti- [fol. 15] tioner or other mills, likewise situated, seeking to sequester and administer said funds in separate suits and actions known as "class suits," all of which matters delayed the final determination of the fair and just settlement to be made by the vendees and the petitioner. That consistent with the attitude of the petitioner in its dealings with its vendees, and on the — day of December, and under the date of November 7, 1936, the petitioner mailed to its vendees and customers, particularly those with *hom*

settlements and adjustments were thereafter made, a letter, reading, in substance, as set forth in Exhibit "A" hereto attached; said Exhibit "A" being attached hereto, and made a part of this amended and supplemental petition as if fully set forth herein in full.

That from time to time during the year 1936, and in the year of 1937, while said petitioner was being delayed in the settlements to be made and which it recognized should be made to its customers, it received from time to time letters from said customers urging the petitioner to make adjustments of the liability of petitioner for processing taxes to such vendees during said injunction period and that from time to time thereafter, the petitioner advised said vendees of the difficulties it was encountering which delayed the settlement, but promising said vendees that they would be treated fairly and that The Security Flour Mills Company would do the right thing by said customers as soon as the rights and liabilities could be determined.

That during said time and from time to time during the time intervening between the final judgment in said suit, and the date upon which settlement was actually made, the petitioner, its officers, sales managers and representatives had frequent talks with the said customers and vendees in which the said representatives of said petitioner advised said vendees they would be treated fairly, and that The Security Flour Mills Company would do as well by its customers as other mills would do by their customers. That said petitioner had many conferences with said vendees, and discussed settlement.

(5-a-4) That during all the times from the date of the [fol. 16] receiving of said funds from said The Fourth National Bank, until the date upon which settlement was actually made, the petitioner continued to keep said funds in a reserve account for the benefit of its said vendees to the extent that settlement was thereafter to be made with such vendees. That thereafter, and during the year 1937, the said petitioner did finally settle with and pay to the said vendees in most instances a sum equal to One Dollar ($1.00) per barrel upon flour thus sold and shipped to the customer and vendee during the pendency of said injunction and prior to the 6 day of January, 1936. That the total amount of money paid to said vendees and charged to said separate account, as aforesaid, was the sum of

Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90). That until the time of the settlement of said controversies with said vendees to whom said petitioner was liable, it did not assert any right to, nor make claim to all of said vendees, but recognized that said funds were held to the extent and for the use and benefit of vendees to the amount that said petitioner was liable to them in the making of settlement, as aforesaid.

(5-a-5) That during all of said time the said petitioner was consistent in that it recognized its liability to make some satisfactory settlement with its vendees. That for the purpose of advising the Board of Tax Appeals as to the manner of keeping said account, a transcript of said account is hereto attached, marked Exhibit "C," and made a part of this petition.

(5-a-6) That this petitioner further alleges that in the making of said arrangements with its vendees, in receiving said moneys and crediting the same to said account and in making distribution thereof, it was consistent, and at all times recognized that it had a known liability to its vendees, although the amount was not immediately known. That said funds were held in said manner until said settlements were made and said petitioner at no time denied its liability to certain of its vendees in such amount as may be determined to be justly due and owing to them.

(5-a-7) Petitioner further states that in the keeping of [fol. 17] said account in the handling of said funds, and as was its right under the provisions of Section 41, 42 and 43 of the Revenue Act of 1934 to keep its accounts in such a manner as to fairly reflect income, that it did not assert ownership or title to such part of said funds as might be necessary for settlement with its customers, and that in the keeping of its books and records, as herein alleged, it did so in such a manner that said books and records would, in truth and in fact, reflect its income. That in accruing for the benefit of its customers that portion of the funds so received and held by said petitioner's vendees, the said petitioner kept its books and records so that they would properly reflect its obligations 'paid and accrued' or 'paid and incurred,' and adopted said method of accounting upon the basis upon which its net income was computed.

That said books and records as established, kept, maintained and adopted by said petitioner clearly reflected the income for the period in question, and for the Commissioner to assess an additional tax upon any other basis would distort, disrupt and fail to reflect the taxable income of this petitioner. That the petitioner alleges that its books and records in the handling of said matters did in fact properly reflect the income of this petitioner, and that any other manner of handling or dealing with said transaction would, in truth and in fact distort its income contrary to and in violation of the provisions of the statutes, laws and regulations relating thereto.

Petitioner further alleges that at all times herein material, for many years prior thereto, this petitioner kept its accounts upon an accrual basis, made its reports to the Bureau of Internal Revenue on such basis and has since so kept its books and records, and that at no time material herein has it ever kept its records upon a cash basis.

(6) The petitioner makes the facts herein alleged applicable to both its original assignment of errors as set forth in paragraph (4-a) above, and likewise applicable to the alternate paragraph (4-b) above to the same extent and in the same manner as if said facts were restated and realleged as to each of said original and alternate assignments.

[fol. 18] (7) With reference to assignment of error (4-c), the petitioner alleges the facts to be:

That the inventories apparently used by the Commissioner were the amounts of inventories upon the books at the end of said taxable year, to-wit: December 31, 1935, without making the proper allowance, adjustments and corrections therefor which should have been made due to the fact that the commodities shown by said inventory in truth and in fact contained inflated and improper amounts of inventory values due to the fact that there was included in said inventories the tax at the rate of One and 38/100 Dollars ($1.38) per barrel on such flour so inventoried; whereas, in fact, the Examiner in making his report to and the letter of deficiency by said Commissioner of Internal Revenue allows a reduction of but Two Thousand Four Hundred Fifty and 2/100 Dollars ($2,450.02), when in fact the proper adjustment in inventory should have been Two

Thousand Seven Hundred Forty-seven and 34/100 Dollars ($2,747.34), thus making an additional reduction in inventory and, therefore, reduction in gross income to which this petitioner is entitled.

Wherefore, petitioner prays that this Board may hear the proceedings and find and determine:

(a) That the petitioner is entitled to deduct from gross income in the taxable year in question, the amount of One Hundred One Thousand Seven Hundred Eighty-three and 89/100 Dollars ($101,783.89), being the amount of funds impounded which should not be held or determined to be a part of the gross income of the petitioner for the taxable year of 1935; the same being the amount of said impounded funds, plus the tax upon the processing by petitioner during the month of December, 1935, and which sum is not lawfully to be included within petitioner's income for said year.

(b) That as shown by the facts herein alleged, the amount of the petitioner's gross income for the year 1935 should be reduced by the amount of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90) and its taxable income for said period accordingly reduced.

[fol. 19] (c) That the petitioner was, during, all times herein material, upon an accrual basis in reporting its taxable income, and that the manner of keeping its books and records properly reflect income of the petitioner, and that any change or other manner of handling said items would distort income and fail to reflect the taxable income of this petitioner.

(d) That the petitioner had a regular contractual and definite knowable, if not known, liability to its vendees, was obligated to and held for their use and benefit the said sum of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90) thus paid to them, and that said item was not the income of this petitioner, nor was said sum the money of this petitioner, or otherwise to be included in law as a part of its gross income.

(e) That the payments by the petitioner to its vendees in the sum of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90) be held and determined to be readjustment in original sales price and hence allocable to the year of sale and shipment.

(f) That the sum of Forty-five Thousand Eight Hundred Sixty-five and 90/100 Dollars ($45,865.90) reimbursements to its vendees, as herein alleged, was knowable, though not known liability in the year of sale and is, therefore, not properly to be included within the gross income of said petitioner for said year of 1935.

(g) That the petitioner be determined to be entitled to a reduction from gross income in the matter of its inventories on account of the facts herein alleged to the extent of Two Hundred Ninety-seven and 32/100 Dollars ($297.32).

(h) The petitioner further prays that the Board of Tax Appeals adjust and determine the true liability of said petitioner for income tax for the year 1935, and if the computation with the allowances herein requested result in an overassessment of such tax, then the Board [fol. 20] determine and adjust the amount of such overassessment to this petitioner in its order, judgment and findings.

Robert C. Foulston, Suit 608 Fourth National Bank Bldg., Wichita, Kansas; Vincent A. Smith, 307 Wheeler Kelly Hagny Building, Wichita, Kansas; Harry E. Lunsford, Parry Barnes, 21 West Tenth Street, Kansas City, Missouri, Attorneys for Petitioner.

[Verification omitted.]

EXHIBIT "A" TO AMENDED AND SUPPLEMENTAL PETITION

Treasury Department

Washington June 21, 1937

Office of Commissioner of Internal Revenue.

Address Reply to Commissioner of Internal Revenue and refer to

Security Flour Mills Co., Abilene, Kansas.

SIRS:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1935, discloses a deficiency of $14,702.48 and that the determina-

tion of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $3,088.80 as shown in the statement attached.

In accordance with section 272(a) of the Revenue Act of 1934, notice is hereby given of the deficiencies mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies above stated.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing and filing of this form will expedite the closing of your return(s) by permitting [fol. 21] an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner; by Chas. T. Russell, Deputy Commissioner.

Enclosures: Statement, Form 870.

EXHIBIT "B" TO AMENDED AND SUPPLEMENTAL PETITION

November 7, 1936.

TO OUR CUSTOMERS:

This company became subject to and liable for wheat processing taxes on July 9, 1933, and paid such taxes to the Treasury Department of the United States until, when it became evident that it was possible to secure a restraining order preventing that collection of the tax until its constitutionality had been determined by the Supreme Court we applied for and secured our injunction.

The decision of the United States Supreme Court invalidating the Agricultural Adjustment Act and all taxes levied thereunder was made public on January 6, 1936, but in most cases several weeks elapsed before final adjudication of the status of unpaid taxes because of attempts of vendees to intervene and for other reasons. During this period it became increasingly evident that the Administra-

tion would make strong efforts to secure the passage of legislation which would accomplish the recapture of all or a major part of these unpaid taxes. As a result of the policies and announced desires of the Administration there was included in the Revenue Act of 1936 a section designated as 'Title III—Tax on Unjust Enrichment' (the so-called Windfall Tax) levying a tax 80% on that portion of unpaid processing taxes actually passed on by the processor, or, in the case of refunds and reimbursements by the processor to his vendees, of 80% of such amounts if passed on to the public or others by the vendee. The same th
[fol. 22] is further expressed in the Revenue Act of 1936 in another section, Title VII, which provides that no refund of processing taxes actually paid will be made except to the extent that a processor can prove he actually bore the burden of such tax.

The Title of the 'Tax on Unjust Enrichment' and the principles of the refund adjustments offered by Title VII are derived from the accepted legal doctrine of unjust enrichment as applied by the United States Supreme Court to similar situations which have arisen with respect to Federal Excise Taxes in the past. Our understanding of this doctrine is that the law will not compel the recovery of amounts erroneously paid as taxes if the person seeking such recovery was not the person who actually bore the burden of the tax.

The provisions of the Windfall Tax section of the law and the regulations thereunder issued by the Commissioner of Internal Revenue are somewhat ambiguous and extremely complex. It appears to be the intent of the law that no refund by a processor to his vendee will be recognized unless based on a written agreement entered into prior to March 3, 1936, or paid before June 1, 1936, and then only if such refund is for the exact amount of tax passed on.

The regulations appear to be somewhat more liberal than the law itself in this respect and, while the Treasury Department has issued a ruling to the effect that payments or credits to vendees who purchased flour under the standard Miller's National Federation sales contract (issued February 21, 1935, and July 3, 1935) will be recognized as payments made under a 'written agreement' as defined in the statute, the ruling does not conclusively state that payments made because of the existence of the standard sales contract will meet the requirements of the statute other-

wise than with respect to having been made in accordance with the terms of a written agreement. Furthermore, the ruling is an administrative one only and is subject to alteration, amendment or withdrawal by the same authority issuing it and can certainly have no effect in the event that any court of competent jurisdiction should hold to the contrary, no rulings or authoritative opinions are as yet available as to the effect on the income and excess profits [fol. 23] taxes of the processor of refunds or credits made in one year with respect to transactions occurring in a prior year, particularly where such refunds are made the basis of an agreement to settle other claims or disputed between the processor and his vendee.

The entire situation has been further complicated by the filing of 'class suits' against processors seeking to recover for customers as a class the full amount of unpaid processing taxes. The nature of these proceedings is that an attorney representing one or more vendees brings an action on behalf of his clients and asks that all similarly situated vendees of the defendant processor be included in the action. Attorneys' liens are then filed which seek to prohibit settlement with any vendee except through the attorney of record whether or not such vendee has any knowledge of the proceeding. These 'class suits' have been filed against many flour millers and if such action has been or should be taken against us it will obviously be impossible to take any settlement while such action is pending, anything to the contrary hereinafter stated notwithstanding.

We have given consideration to an attempt to define a proposed method of settlement with our customers through the medium of securing a 'closing agreement' with the Treasury Department. We were advised, however, by our attorneys and accountants that such an agreement, made in advance of the actual occurrence of the transactions involved, to permit the immediate repayment to vendees of a stated sum cannot possibly offer either to the processor or the vendee the degree of financial security requisite in the disbursement of the comparatively large sums involved since obviously such an agreement cannot relate to anything other than the definition of basic principles involved in the final settlement of various forms of tax liability after all transactions have been completed.

In spite of all the difficulties we have referred to, we believe that we have now developed a method of procedure which will offer a solution. We propose to make formal application to the United States Treasury Department for permission to make settlement with our flour-buying customers on the following basis:

[fol. 24] (a) We will prepare the *require-* 'Unjust Enrichment' or 'Windfall Tax' returns and have them examined and audited by the Treasury Department, in conjunction with our income and excess profits tax returns, for the purpose of securing final definition of our tax liability and the amount of unpaid processing taxes passed on to our customers.

(b) As such latter amount has been determined and accepted by the Treasury Department as the amount of 'Unjust Enrichment' on which we would be subject to tax, we shall request permission to refund the whole of such amount (less expenses incurred in connection therewith) to our customers who purchased the flour made from wheat with respect to which a tax was imposed but not paid (except flour of our manufacture in transit or otherwise included in customers' floor stocks on January 6, 1936), provided

1. That the Treasury Department will accept such repayment as an offset against 'Windfall' income and excess profits tax liabilities for the period during which the processing taxes were imposed but not paid and

2. That the customer will accept such basis of settlement as satisfaction of any claims he may assert with reference to such funds. In any case where the customer does not accept this basis, or in case the Treasury Department decides that where flour was sold without formal contract the customers has no interest in the funds, the eighty per cent tax will be paid to the Treasury.

(c) With respect to process taxes actually paid by us, it is not contemplated that you will be asked to waive any rights you may be legally able to assert in connection therewith, nor that we will waive any similar rights we may be able to assert. The provisions of Title VII preclude the possibility of the processor recovering any amount of taxes paid except such sums as he can prove were actually borne

by himself. If, however, Title VII should be declared unconstitutional, or if by any other means we can recover the entire amount of the taxes actually paid, we shall agree to settle with you with respect to those taxes on the same basis as hereinbefore described with respect to process taxes which were not paid. The validity of Title VII is now being contested in the Federal Courts.

[Fol. 25] We feel that the method of settlement herein outlined is eminently fair inasmuch as the basis is to be finally determined in conjunction with the Treasury Department of the United States which is a party at interest inasmuch as any amount approved by them for refund to you is still subject to the eighty per cent Windfall Tax in your hands, and consequently we feel sure that every effort will be made by them to see that the amount finally determined upon is correct. We believe it hardly necessary to call to your attention the fact that the offer herein is made is a voluntary one on our part and is not to be construed as in any manner admitting any liability whatsoever to you or to any customer with respect to process taxes assessed or assessable against us whether or not such taxes were paid.

We regret very much that this entire matter has been a possible source of irritation to you. We trust that you will realize that it has been a tremendous burden to us and a source of considerable expense and has consumed a large amount of our time. We are under the necessity of protecting ourselves from further losses and, while we are extremely anxious to have the entire matter adjusted at the earliest possible moment, we believe that it will require the fullest degree of co-operation among yourselves, ourselves and the Treasury Department of the United States in order to accomplish this end.

EXHIBIT "C" TO AMENDED AND SUPPLEMENTAL PETITION

The Security Flour Mills Company, Abilene, Kansas, Analysis of Reserve for Processing Tax Claims, Etc., Account.

	Debit	Credit
Excess of processing tax accrued on shipments to Illinois state institutions, not paid to Collector		$ 92.64
Excess of processing tax accrued and charged to operations for July, 1935, not impounded		206.00
Excess of processing tax accrued and charged to operations for August, 1935, not impounded		195.00
[fol. 26] Excess of processing tax accrued and charged to operations for October, 1935, not impounded		690.00
Amount of processing accrued and charged to operations for December, 1935, not impounded		9,896.66
Dec. 31, 1935 Balance		11,080.30
Refunds to vendees and adjustment of sales price of shipments in transit on Jan. 6, 1936. These refunds made during January and February, 1936	$3,181.59	
Feb. 12, 1936 Return of impounded funds from The Fourth National Bank, Wichita, Kansas, previously charged to operations		93,974.40
Total expenses paid chargeable to this account, including legal fees, accounting fees, court costs, etc., paid during 1936	3,278.34	
Mar. 14, 1936 Tax in inventory as of Dec. 31, 1935 credited to inventory account	2,573.27	
	9,033.20	105,054.70
Dec. 31, 1936 Balance—(Forward)		$ 96,021.50

Exhibit C (Page 2).

The Security Flour Mills Company, Abilene, Kansas, Analysis of Reserve for Processing Tax Claims, Etc., Account.

	Debit	Credit
Dec. 31, 1936 Balance—(Forward)		$96,021.50
May 18, 1937 Refund from vendor on flour purchased during injunctive period		200.00
[fol. 27] Refunds made during 1937 to vendees on shipments of flour made during the injunctive period	$41,879.50	
Total expenses paid during 1937	2,651.01	
	44,530.51	96,221.50
Dec. 31, 1937 Balance		51,690.99
Total expenses paid during 1938	529.53	
Refunds made during 1938 to vendees on shipments of flour made during the injunctive period	1,511.37	
	2,040.90	51,690.99
Dec. 31, 1938 Balance		49,650.09
Total expenses paid during 1939	2,954.77	
Payment of Title III tax, net, under Section 506	16,405.33	
Balance transferred to Surplus Account	30,289.99	
	$49,650.09	$49,650.09

Summary of Reimbursements to vendees on shipments of flour made during the injunctive period:	Applicable to Shipments made during Year Ended December 31	
	1935	1936
Paid during year 1936	$ 2,475.03	$ 706.56
Paid during year 1937	41,879.50	None
Paid during year 1938	1,511.37	None
	$45,865.90	$ 706.56

[File endorsement omitted.]

[fol. 28] BEFORE UNITED STATES BOARD OF TAX APPEALS

ANSWER TO AMENDED AND SUPPLEMENTAL PETITION—Filed November 28, 1939

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchell, Chief Counsel, Bureau of Internal Revenue, and for answer to the amended and supplemental petition filed in the above-entitled proceeding admits, denies and avers as follows:

(1) Admits the allegations contained in paragraph (1) of the amended and supplemental petition.

(2) Admits that the notice of deficiency was mailed to the petitioner on June 21, 1937, but denies that a copy thereof was attached to the amended and supplemental petition.

(3) Admits that the taxes in controversy are income and excess profits taxes for the calendar year ended December 31, 1935. Denies the remaining allegations contained in paragraph (3) of the amended and supplemental petition.

(4-a) to (4-d), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (4-a) to (4-d), inclusive of paragraph (4) of the amended and supplemental petition.

(5-a-1) Admits that the petitioner, at all times material herein, conducted a flour milling business at Abilene, Kansas. Denies the remaining allegations contained in subparagraph (5-a-1) of paragraph (5) of the amended and supplemental petition and avers that the said matter is incompetent, irrelevant and immaterial in that it does not tend to prove or disprove any issue in this proceeding.

(5-a-2) Admits that on the 29th day of June, 1935, this petitioner caused to be instituted in the District Court of the United States for the District of Kansas, an action entitled, "The Security Flour Mills Company, plaintiff, vs. H. D. Baker, Individually, and as Collector of Internal Revenue for the District of Kansas, defendant," wherein the plaintiff sought an injunction against the said Collector of Internal Revenue to enjoin the further collection of processing taxes under the terms of the Agricultural Adjustment Act. Admits that on the 24th day of July, 1935, a temporary injunc-

tion was issued by the Judge of said Court, enjoining the further collection of said tax on condition that in lieu of bond the plaintiff would file information returns with the Collector of Internal Revenue and would deposit in The [fol. 29] Fourth National Bank in Wichita, Wichita, Kansas, a sum of money equal to the tax otherwise due as shown by such returns. Admits that from May 1, 1935, the effective date of said order, to and including December 31, 1935, the petitioner paid into said Fourth National Bank in Wichita, Wichita, Kansas, the total sum of $93,974.40. Admits that on the 28th day of February, 1936, there was entered by the District Court in the proceeding herein above mentioned an order making permanent the injunction in said case and directing the return and repayment to the petitioner of the sum of $93,974.40, therein before held by The Fourth National Bank in Wichita, Wichita, Kansas. Denies the remaining allegations contained in subparagraph (5-a-2) of paragraph (5) of the amended and supplemental petition.

(5-a-3) to (5-a-7), inclusive. Denies the allegations contained in subparagraphs (5-a-3) to (5-a-7), inclusive, of paragraph (5) of the amended and supplemental petition.

(6) Admits the matter set forth in paragraph (6) of the amended and supplemental petition.

(7) Denies the allegations contained in paragraph (7) of the amended and supplemental petition.

(8) Further answering the amended and supplemental petition for an affirmative defense, respondent alleges that he erroneously computed and determined petitioner's income and excess-profits taxes for the taxable year ended December 31, 1935. That the true deficiency for the said year is $15,066.75 in income tax and $3,221.27 in excess-profits tax, as is shown by the statement attached hereto marked respondent's exhibit No. 1 and by reference made a part hereof.

(9) That the respondent relies upon the following facts:

A. That the petitioner filed a claim (No. F 1269) with the Commissioner of Internal Revenue in accordance with Title VII of the Revenue Act of 1936 for a refund of certain processing taxes paid to the Collector of Internal Revenue under the Agricultural Adjustment Act.

B. That the petitioner was allowed a refund by the Commissioner of said processing taxes in the total prin- [fol. 30] cipal amount of $15,928.85, of which latter amount $2,649.25 pertained to the taxable year 1935.

C. That the said amount of $2,649.25 was entered on the petitioner's books as an accrued liability for the year 1935, and was actually paid to the Collector of Internal Revenue within the latter year.

D. That the said amount of processing taxes ($2,649.25) was claimed and allowed as a deduction in the petitioner's Federal income tax return for the taxable year 1935.

E. That the said amount of processing taxes ($2,649.25) was not a proper deduction in the petitioner's Federal income tax return for the taxable year 1935.

Wherefore, it is prayed that the Board redetermine the amounts of the deficiency in income and excess-profits tax involved in this proceeding for the taxable year ended December 31, 1935, to be equal to the amounts determined by the Commissioner plus the additional amounts arising from the correction of the error committed by the Commissioner. Claim is hereby asserted for the increased deficiency of $15,066.75 in income tax and $3,221.27 in excess-profits resulting from said redetermination in lieu of the amounts previously determined by the Commissioner.

J. P. Wenchel, R. P H, Chief Counsel, Bureau of Internal Revenue.

Of Counsel: R. P. Hertzog, Division Counsel; J. Y. Porter, Special Attorney, Bureau of Internal Revenue.

EXHIBIT No. 1 TO ANSWER

The Security Flour Mills Company

Recomputation of Income and Excess-Profits Taxes for the Taxable Year Ended December 31, 1935.

Net income as shown in statutory notice dated June 21, 1937	$114,050.23
Add:	
Refund of processing taxes	2,649.25
Net income as corrected	$116,699.48

[fol. 31]

Tax Computation

Income Tax

Net income as corrected	$116,699.48
Tax at 13¾%	16,046.18
Tax assessed, #401621	979.43
Deficiency	15,066.75

Excess-Profits Tax

Net income as corrected	$116,699.48
Less: 12½% of declared value of capital stock	52,274.16
Balance taxable at 5%	64,425.32
Tax at 5%	3,221.27
Tax assessed	None
Deficiency	3,221.27

[File endorsement omitted.]

BEFORE UNITED STATES BOARD OF TAX APPEALS

REPLY OF PETITIONER TO THE ANSWER OF THE RESPONDENT TO AMENDED SUPPLEMENTAL PETITION—Filed November 29, 1939

Comes now the petitioner, The Security Flour Mills Company, and for its reply to the answer of the respondent to amended and supplemental petition, and with particular reference to the new matter contained therein, states:

First: For reply to Paragraph 8, the petitioner admits that the respondent erroneously computed and determined

petitioner's income and excess profits taxes for the taxable year ended December 31, 1935, but denies that the true deficiency for the said year is $15,066.75 in income tax and $3,221.27 in excess profits tax, as shown by the statement attached to said answer and marked respondent's Exhibit "1" and made a part of said answer, in that the correct deficiency of petitioner for income and excess profits taxes for the taxable year ended December 31, 1935, is as claimed and set forth in the amended and supplemental petition of the petitioner.

Second: With reference to Paragraph (9-A), the peti- [fo]. 32] tioner admits that it filed a claim (F-1269) with the Commissioner of Internal Revenue in accordance with Title VII of the Revenue Act of 1936 as alleged in said Paragraph (9-A).

Third: The petitioner denies the allegation of Paragraph (9-B) of said answer in the sum of $15,928.85, or that the sum of $2,649.25 pertained to the taxable year 1935, and in explanation of said denial the petitioner states that it entered into a closing agreement under Section 506 of Title III of the Revenue Act of 1936, as shown by the copy of said closing agreement attached to the stipulation of facts and made a part thereof. That the petitioner received a notice and demand pursuant to said agreement in which an amount of $16,405.33 was demanded of said petitioner, as shown by Exhibit "E" attached to said stipulation of facts. Said demand recited "1935 unjust enrichment tax." That said petitioner paid an amount shown by said notice and demand, as shown by said exhibit.

The petitioner, further replying, admits that a summary accompanying said closing agreement was considered by the Commissioner in connection with his determination as to whether he would or would not make the settlement of the tax liability as set forth in said closing agreement; but petitioner alleges that said schedule does not constitute any part of said agreement. Petitioner further alleges that the Commissioner considered the tax liability of the petitioner for unjust enrichment tax arising under said Title III of the Revenue Act of 1936 in conjunction with said claim for refund under Title VII. That in making said closing agreement, the Commissioner considered the liability of said petitioner for unjust enrichment tax and such claim under

Title VII as one case, and entered into such written agreement under Section 506 of Title III of the Revenue Act of 1936 for the settlement of the tax liability in such case upon the payment by the petitioner of the amount specified in said agreement, to-wit: the sum of $16,405.33. That such agreement constitutes a final settlement of the liability for tax and the claim for refund covered thereby.

That, for the reasons set forth in this paragraph and with the explanation therein contained, the petitioner denies Paragraphs (9-C), (9-D) and (9-E) of said answer.

[fol. 33] Wherefore, petitioner prays a determination, judgment and finding as claimed and demanded in its amended and supplemental petition.

For like reason, petitioner prays that the claim affirmatively asserted by the respondent in its answer to amended and supplemental petition shall be denied.

Robert C. Foulston, Suite 608 Fourth National Bank Building, Wichita, Kansas; Vincent A. Smith, 307 Wheeler Kelly Hagny Building, Wichita, Kansas; Harry E. Lunsford, Parry Barnes, 21 West Tenth Street, Kansas City, Missouri, Attorneys for Petitioner.

[File endorsement omitted.]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Findings of Fact and Opinion—Promulgated November 12, 1941

1. Petitioner, after receiving in 1936 a substantial amount of processing taxes impounded in court prior to invalidation of the act under which such taxes had been imposed, reimbursed some of its vendees for a portion of the processing tax which had been included in the price of wheat products sold to them in 1935. Held, following Cannon Valley Milling Co., 44 B. T. A. 763, that the amounts so paid to vendees are deductible in computing petitioner's net income for 1935.

2. Under a closing agreement, executed in 1939, settling petitioner's liability for tax on unjust enrichment and its claim for refund, a portion of the processing tax, which had been deducted from gross income for 1935, was re-

funded. Held, following E. B. Elliott Co., 45 B. T. A. 82, that, inasmuch as the year 1935 is open, adjustment of the deduction for taxes should be made for that year.

Robert C. Foulston, Esq., Harry E. Lunsford, Esq., and Vincent A. Smith, C. P. A., for the petitioner.

R. P. Hertzog, Esq., and J. Y. Porter, Esq., for the respondent.

[fol. 34] The Commissioner made several adjustments to the net income reported by petitioner in its income and excess profits tax return for the calendar year 1935 and determined a deficiency in the aggregate amount of $17,791.28, $14,702.48 being income tax and $3,088.80 excess profits tax. In an amended answer he asserts a claim for an increased deficiency alleging that the correct amount is $18,288.02, of which $15,066.75 is income tax and $3,221.27 is excess profits tax.

Several of the adjustments made by the respondent are conceded by petitioner to be correct. The issues to be decided arise in connection with certain processing taxes. Between May and December in 1935, processing taxes amounting to $105,054.70 were accrued upon petitioner's books and deducted in computing its income. Most of this amount had been impounded under order of court and, during the succeeding taxable year, was returned to petitioner following a judicial determination that the processing tax act was invalid. During 1936, 1937, and 1938, $45,865.90 was paid over by petitioner to its vendees to reimburse them for the processing taxes which they had paid to petitioner and which petitioner had not been required to pay over to the Government. The first question is whether the sum of $45,865.90 constitutes, and may be allowed as, a deduction from petitioner's gross income for 1935. The second question is whether petitioner's tax liability for 1935 may be increased by reason of a closing agreement, executed by the parties in April 1939, under section 506 of the Revenue Act of 1936, settling petitioner's liability for unjust enrichment tax under Title III and its claim for refund under Title VII of said act.

The proceeding was submitted upon a stipulation of facts, oral testimony, exhibits, and a supplemental stipulation of facts. All facts contained in the stipulations are found to

be as stipulated, whether specifically set out in our findings or not. From the whole record we make the following findings of fact.

Finding of Fact

Petitioner is a corporation organized and existing under the laws of the State of Kansas, with its principal place of business at Abilene, Kansas. It filed a corporation income [fol. 35] and excess profits tax return for the year 1935 in which it reported its net income on the accrual basis.

At all times material hereto petitioner was engaged in the manufacture and sale of wheat flour. It was a first domestic processor of wheat and, as such, was subject to the processing tax levied under the Agricultural Adjustment Act at the rate of 30 cents per bushel of clean dry wheat processed between July 9, 1933, and January 6, 1936.

During the period from January 1, 1935, to May 1, 1935, petitioner paid to the collector of internal revenue certain processing taxes (not in issue herein) and claimed and was allowed the amount so paid as a deduction from gross income in its Federal income tax return for the year 1935.

On June 29, 1935, petitioner caused to be instituted, in the District Court of the United States for the District of Kansas, a suit seeking to enjoin the further collection from it of processing taxes levied under the authority and provisions of the Agricultural Adjustment Act. The court granted a temporary injunction on July 24, 1935, effective from May 1, 1935, enjoining the further collection from the petitioner of processing tax on condition that it file information returns with the collector and deposit in a bank, designated as the depository of the court, a sum of money equal to the tax shown to be due by such returns, pending the final determination of the constitutionality of the act imposing the tax. Pursuant to such order and during the period May 1 to December 31, 1935, petitioner paid into the designated bank the total sum of $93,974.40 and, for the final month of said period, accrued upon its books as a liability for the processing tax, but did not pay to the collector or to the depository of said court, the sum of $9,896.66, plus an additional item of $1,183.64 representing a reserve for possible increases in the processing tax for prior years.

On February 28, 1936, following the invalidation of the Processing Tax Act by the Supreme Court on January 6,

1936 (United States v. Butler, 297 U. S. 1), the District Court of the United States for the District of Kansas entered an order making permanent the temporary injunction theretofore granted and directed the depository bank to pay over to petitioner the sum of $93,974.40 theretofore de-
[fol. 36] posited by it pursuant to the court's earlier order. This order was complied with and the said sum, on February 28, 1936, was paid to petitioner.

After the invalidation of the Processing Tax Act by the Supreme Court certain of petitioner's vendees filed intervention petitions in the injunction proceeding, seeking to have the impounded moneys returned to them. These petitions were resisted by petitioner upon technical grounds. The intervening petitions were denied on February 28, 1936.

During the calendar year 1936 petitioner, in its books of account, credited the processing tax returned to it pursuant to the order of the District Court to an account designated "Reserve for Processing Tax, Claims, etc." A summary and detailed analysis of this account is attached to one of the stipulations as an exhibit. Briefly, it shows total credits of $105,254.70 and debits of an equal amount, the last debit reflecting a transfer to surplus on June 30, 1939, of $30,289.99. Other debits were made to the account between January 1, 1936, and June 30, 1939, for legal fees, accounting fees, court costs, payment of Title III tax and reimbursements to vendees on shipments of flour made during the injunctive period. A summary of the last mentioned item shows $2,475.03 paid in 1936, $41,879.50 paid in 1937, and $1,511.37 paid in 1938.

After the injunction had been made permanent and the money which had been impounded had been released to petitioner, certain of its vendees instituted suit against it, claiming to be entitled to $1.38 per barrel of flour purchased by them during the injunctive period. The action was founded upon the Miller's Federation Uniform Sales Contract and upon quasi contractual and equitable trust fund theories. The suits were resisted and ultimately dismissed.

Petitioner's sales of flour from May 1 to December 31, 1935, were made at a stated price per barrel. The selling price consisted of the usual items of cost, plus normal profit, and included in addition an amount sufficient to cover the processing tax. The invoice reflected the contract price, but did not show the tax as a separate item. The contract price was included in the gross sales entered on petitioner's

books. More than 50 percent of such sales were made under the Miller's Federation Uniform Sales Contract re-
[fol. 37] ferred to above. The pertinent reference to processing taxes in the contract is as follows:

The price named in this contract includes all taxes as at the date hereof proclaimed by the Secretary of Agriculture by virtue of the authority vested in him by the Agricultural Adjustment Act. * * * Under said Act it is provided that said taxes may be changed from time to time. It is recognized * * * that there is a growing tendency on the part of the United States and the separate states to tax grain * * * used in connection with the manufacturing, processing, blending, sale or distribution thereof. It is therefore agreed * * * that if, after the date of this contract, the commodities * * * used in connection with the manufacturing, processing, blending, sale or distribution thereof, shall become subject to any increase in taxes or to any new or additional tax or taxes other than those included in the price hereof, (if the seller shall be required by law to collect such increases or additional taxes) * * * said increases or additional taxes shall be added to the price hereof; and correspondingly if any tax included in the price hereof shall be decreased or abated, then in that event, said decrease or abatement shall be deducted from the price hereof.

Petitioner had been advised by counsel as early as July, 1935, that the Government intended, if the act should be held invalid, to recapture by new legislation a large part of the unpaid processing taxes, and that it would be inadvisable to make any commitments to refund any definite amount or any percentage of the tax to its customers, since by agreeing to do so it might seriously impair its financial condition. On June 22, 1936, Congress enacted the Revenue Act of 1936, providing in Title III for the imposition of the unjust enrichment tax and in Title VII for the refund of taxes paid under the Agricultural Adjustment Act. Petioner's counsel sought a ruling by the Treasury Department on the question whether the Miller's Federation Contract was an agreement, within the meaning of Title III, entitling petitioner to credit against its taxes under that title for any refunds made to vendees under Title VII. In the meantime counsel continued to advise petitioner not to make any definite commitments to its customers with reference to refund of the processing tax to them.

[fol. 38] The petitioner, pursuant to the advice of its counsel, refrained from making any definite promises respecting refunds in all written communications to its vendees. After the suit for injunction had been filed, and up to the latter part of 1936, petitioner, through its officers, salesmen, and brokers, orally informed some of its vendees that it proposed to make an agreement with them as soon as all matters with respect to the impounded fund and unpaid taxes should be finally settled. It was stated that petitioner would treat them fairly and do as well by them as other mills similarly situated, but that no promise could be made to refund any definite amount to them. Petitioner considered the tax clause of the Miller's Federation Contract to be applicable only to increases or decreases in the price between the date of the order and the date of shipment and not as creating any obligation to refund part of the price in case of invalidation of the act. The above promises of fair treatment were made independently of that clause. They were made without approval of counsel, who intimated that they might be construed as creating a legal obligation.

In November 1936 petitioner informed some of its vendees, who had purchased flour under the Federation Contracts, that it intended to seek a final determination of its tax liability by the Treasury Department, and, after the amount of unpaid processing taxes passed on to vendees on which it would be subject to tax had been fixed, that it would seek permission to refund the whole of such amount to vendees, provided the Department would accept such repayment as an offset against "Windfall," income, and excess profits tax liabilities and provided the vendees would accept such amount in satisfaction of their claims. The petitioner was informed by its counsel later in 1936 that the Treasury Department had agreed to allow credit for reimbursements and that it should proceed to make settlements with its vendees. Petitioner thereupon commenced negotiations with some of its vendees and made agreements with some of them as to the amount to be repaid to them.

During 1936, 1937 and 1938 drafts in various amounts were issued by petitioner to the vendees with whom agreements were made, aggregating (together with credits against the accounts of some of them) $45,865.90 ($2,475.03 [fol. 39] in 1936, $41,879.50 in 1937, and $1,511.37 in 1938). Attached to each draft and made a part of it was a "Release Agreement," which, after referring to the difficulty of de-

termining the exact amount of the processing tax which had been borne by the vendor and the vendee, recited that "the amount of the taxes shifted to vendee * * * was not more, and may be less than" the total of the draft and credit memorandum referred to in the agreement. By cashing the draft the vendee acknowledged full payment and satisfaction of, and discharged the vendor from, all demands, charges, claims, actions, and rights of action growing out of amounts paid an account of processing tax during the injunctive period and included in or added to the price of flour sold by the vendor to him; covenanted that he was the actual purchaser of the flour and the owner of the claim, that he was not a party to any pending action against the vendor, and that he had not authorized the institution or prosecution of any suit or action against it. The agreement also stated that nothing therein was to be construed as, or constitute an admission of, liability of the vendor to any other person, firm, or corporation and that all legal and equitable defenses, of which it might be possessed, in any and all pending and future litigation against it, were expressly reserved.

Petitioner did not make refunds to all who had purchased flour from it during the injunctive period. Refunds were made to some customers who had purchased under Miller's Federation Contracts, irrespective of whether or not they had been promised fair treatment. In making refunds only regular customers were considered, and a large number of casual customers, or customers toward whom the petitioner felt no obligation, were ignored. The petitioner made no attempt to effect settlements with those to whom the promises to treat fairly had been made but who had not purchased under the Miller's Federation Contracts.

On a schedule attached to petitioner's income tax return for the year 1935 petitioner deducted from the amount of $908,613.29 shown as "Gross Sales, per Books," the amount of $106,604.02 as "Provision for allowances to Vendees of Processing Taxes." It added the amounts of the impounded funds returned to it in 1936 and accrued processing taxes which had not been paid, namely, $103,887.54, reporting the [fol. 40] resulting figure of $905,896.81 as "Net Sales." The amount of $908,613.29 represents the amount arrived at after deducting from total gross sales amounts aggregating $163,526.21 representing estimated processing taxes collected from vendees during the year. Petitioner's total

gross sales for 1935 were the aggregate of the two last mentioned amounts or $1,072,139.50. The sum of $163,526.21 deducted from petitioner's gross sales in its books of account included, among other items, the $93,974.40 impounded in the depository and the $9,896.66 accrued upon petitioner's books as processing taxes for the month of December 1935 but not impounded or paid over to the Treasury Department.

In determining the deficiency the respondent disallowed as a deduction $105,054.70, consisting of the following items:

Processing taxes impounded and later (Feb. 1936) released to petitioner	$ 93,974.40
Accrued processing taxes Dec. 1935. Not impounded or paid over to treasury	9,896.66
Estimated processing reserve set up to provide for additional assessments for prior years	1,183.64
	105,054.70

The petition assigns error in disallowance of $101,783.89 of the above amount as a deduction.

The income tax returns of petitioner for 1936 and 1938 are not in evidence, and the record does not show whether the payments to customers of $2,475.03 and $1,511.37 in those years were claimed as deductions, or whether they were allowed or disallowed by the respondent. Petitioner's income tax return for 1937 shows a net loss of $66,944.25, computed by including in the deductions claimed the sum of $43,390.87 representing payments to customers in that year in settlement of processing tax claims.

Pursuant to the provisions of Title VII of the Revenue Act of 1936, petitioner filed a claim for the refund of processing taxes paid for the period July 9, 1933, to May 1, 1935. This claim was considered by respondent in connection with a settlement of petitioner's tax liability under section 506 of the Revenue Act of 1936. Petitioner and respondent, under date of April 8, 1939, executed a closing agreement [fol. 41] under section 506, supra, wherein they agreed: * * * that the total liability of the taxpayer for tax, penalty and interest under the provisions of Title III of the Revenue Act of 1936 [for taxable years ended prior to January 1, 1938], and the total amount with interest thereon, allowable to the taxpayer as a refund of amounts paid as tax under the Agricultural Adjustment Act, as amended, shall

be finally settled * * * by the payment of * * * $16,405.33 by the taxpayer.

The computation made in connection with the closing agreement discloses a net unjust enrichment tax liability under Title III for 1935, 1936, and 1937, of $36,880.21, a refund under Title VII of $20,474.88, and a net tax payable of $16,405.33. Notice and demand for payment in accordance with the agreement was mailed to the petitioner on April 27, 1939, and the liability of $16,405.33 was paid on May 2, 1939. The sum of $2,649.25 represented processing taxes paid by the petitioner during 1935 and was a part of the deduction claimed for such taxes in its income tax return for that year and allowed in determining the deficiency.

Opinion

Mellott: The findings are more comprehensive than would seem to be required under the issues as stated by us in the beginning. The pleadings, stipulations, evidence, and opening brief of petitioner indicate that we are being called upon to decide whether petitioner properly excluded $106,604.02 from its gross receipts in 1935. The first section of its opening brief concludes: "It is submitted that $106,604.02 of petitioner's 1935 'gross receipts' did not constitute income until the controversies relating thereto were determined in 1937." Petitioner's argument may be summarized as follows:

At the end of the taxable year 1935 it had accrued upon its books $105,054.70 as processing taxes. When the act was declared invalid (January 6, 1936) this amount was restored to income. It says: Since, instanter such unconstitutionality was declared, there accrued or vested a substantial possibility that $1.38 per barrel of flour sold (not "processed") during the injunctive period would have to be disbursed either to customers or to the Government, the [fol. 42] amount of $106,604.02—the estimated amount which it might be required to repay—was set up on its books, held "in abeyance" or in a "suspense account", and excluded from gross income in its return for 1935. Then, says petitioner, in 1937 the controversies as to these moneys were substantially resolved, whereupon it made reimbursements to its customers totaling $45,865.90 with respect to its 1935 sales. It "then recognized as income, for the first time, all of its 1935 gross receipts except the $45,865.90

thereof which it had refunded to customers. It * * * is not now asking that its income be computed upon the basis of actual income less * * * [the $105,054.70]. * * * It asks to be permitted to deduct only such reimbursements as it actually made to its vendees." (The quotations are from petitioner's reply brief.)

Before passing to what seems to be the real issue to be decided on this phase of the proceeding—i. e., the deductibility of $45,865.90 from petitioner's 1935 gross income—it may be stated that petitioner relies upon Commissioner v. Brown, 54 Fed. (2d) 563; certiorari denied, 286 U. S. 556, as authorizing it to set aside the entire $106,604.02 in a "suspense account" and in refusing to include it in gross income because "a taxpayer is not required to report as income that which he may never be permitted to retain. * * *." It points out that the moneys received by it upon the consummation of the injunction suit were "hot moneys"; that it was reasonably certain petitioner would be unable to retain them; that it was legally obligated to repay an equitable portion to its vendees; that it never asserted any claim of absolute ownership to the fund, but treated it as a "suspense account"; and that under the accrual method of accounting such moneys did not become income until all controversy as to their ownership was settled.

The contentions set forth above are not, in our opinion, well founded. No controversy as to the ownership of the proceeds from the sale of petitioner's flour existed. It had increased the selling price of its flour to include the processing tax and the increased price had been paid by its customers with full knowledge of the facts. It had not legally obligated itself to repay any portion of the sale price to its vendees, nor was there any equitable obliga-[fol. 43] tion upon it to do so. As pointed out in Moundridge Milling Co. v. Cream of Wheat Corporation, 105 Fed. (2d) 366, the sales contracts fixed a "composite price" and did not designate the product sold and the tax separately or provide for the refund of any portions of the payments made on past deliveries. Cf. Johnson v. Igleheart Brothers, Inc., 95 Fed. (2d) 4; certiorari denied, 304 U. S. 585. If petitioner were able to save on any of the items going to make up the total cost of the flour which it sold, it thereby increased its profits pro tanto. In our opinion the total

amount received by petitioner from the sale of its flour constituted gross income to it. North American Oil Consolidated v. Burnet, 286 U. S. 417.

Petitioner next contends that it agreed to settle or compromise its vendees' claims for reimbursement in the year of shipment and that therefore, under a ruling of the Department,[1] it is entitled to treat the reimbursements as deductions from gross income for that year. The substance of the ruling is that processors, keeping their accounts and filing their returns on the accrual basis, may deduct from gross income "for the year in which they agreed with the vendees to settle or compromise the disputed claims", the amounts so agreed upon. Petitioner argues that it "acknowledged its liability in 1935 and has maintained a consistent position throughout." It relies chiefly upon the statements made by its officers to its customers to the effect that they would be treated fairly and as liberally as customers of other mills were treated, which, it says, constituted an agreement ultimately carried out. We do not agree with this contention. The so-called "treat fairly" agreements were no more than assurances given by petitioner to its customers to retain their good will. The testimony of petitioner's officers indicates that they did not intend to bind petitioner to make any repayments to its vendees. Petitioner's counsel and auditor had advised that "it was unsafe to make any definite promises as to amounts that might be paid to the flour buyer." The officers recognized—indeed deliberately chose to bind petitioner no further—that whether any amounts were ever paid to its vendees "would depend upon some other agree-
[fol. 44] ment later made." The later agreements, rather than the "treat fairly" promises, were, in our opinion, the bases upon which the payments aggregating $45,865.90 were made.

Having held, as we do that the $45,865.90 must be included in computing petitioner's gross income for the year 1935 and having also held that the payments to its vendees, aggregating that amount, were not made pursuant to a specific obligation incurred during the year 1935, we pass to petitioner's contention that the respondent erred "in failing to give due and proper effect to the requirements of

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[1] G. C. M. 20134, C. B. 1938—1, p. 122

section 41, 42 and 43 of the Revenue Act of 1934 which require the Commissioner to consider credits and deductions for the taxable year in which 'paid or accrued' or 'paid and incurred', dependent upon the method of accounting upon the basis of which the net income is computed and in so disregarding the mandatory provisions of said sections 41, 42 and 43 as to distort and improperly reflect petitioner's income for said period * * *."[2]

The sections relied upon are shown in the margin.[3]

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[2] Paragraph 4 B, amended and supplemental petition

[3] Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

Sec. 42. Period in Which Items of Gross Income Included.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

Sec. 43. Period for Which Deductions and Credits Taken.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed,

[fol. 45] The identical question was before us in Cannon Valley Milling Co., 44 B. T. A. 763, (on appeal C. C. A. 8th Cir.). The petitioner in that case, though under no enforceable obligation in 1935 to pay over to its vendees any of the amount refunded to it in 1936, nevertheless in 1937 paid over a substantial portion of it to them in order to avoid threatened litigation, to keep their good will, and to compromise their claims. We pointed out that the amounts so paid were ordinary and necessary expenses of carrying on a trade or business, citing Superheater Co., 12 B. T. A. 5; affd., 38 Fed. (2d) 69; O'Day Investment Co., B. T. A. 1230; H. M. Howard, 22 B. T. A. 375; International Shoe Co., 38 B. T. A. 81, 95; Helvering v. Hampton, 79 Fed. (2d) 358; and Welch v. Helvering, 290 U. S. 111, and that they were so considered by the Treasury Department;[4] held that section 43 was not meaningless and should be applied in proper cases; expressed the opinion that the Department could not, by regulation, limit the scope of the section; and concluded that the payments made to the vendees should be allowed as a deduction in computing the taxpayer's income for 1935, since they related to the sales made in that year and did not relate to the sales made in the later period. There is no substantial difference between the facts in the instant proceeding and those in the cited case. The $45,865.90 paid by this petitioner to its vendees represented payments under claims relating to sales made in 1935. If such sales had not been made there would have been no basis for the claims and no reimbursements would have been made. On the authority of the cited case and for the reasons stated therein, we hold that the $45,865.90 in issue here should be allowed as a deduction in computing petitioner's income tax for the year 1935.

The remaining issue arises in connection with respondent's claim that $2,649.25 should be added to petitioner's

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unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer there shall be allowed as deductions and credits for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly allowable in respect of such period or a prior period.

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[4] G. C. M. 20134. C. B. 1938—1, p. 122.

gross income for the year 1935. His contention is that [fol. 46] petitioner, in 1939, was allowed a refund of processing taxes in the total principal amount of $15,928.85, of which $2,649.25 pertained to the taxable year 1935. The stipulated facts have been shown in our findings. They are not entirely clear unless reference is made to some of the figures shown in detail in the exhibits.

During the period the processing tax was being collected (1933 to 1935, inclusive) petitioner deducted from its gross income processing taxes aggregating $318,783.78; $89,151.77 was deducted in 1933, $176,761.05 in 1934, and $52,870.96 in 1935. In the computation attached to the closing agreement the Title VII refund was determined to be $15,928.82 and interest was added in the amount of $4,546.06, making a total of $20,474.88. Petitioner's tax liability under Title III, tax on unjust enrichment, was determined to be $36,880.21. The difference between the latter amount and $20,474.88 or $16,405.33 was paid by petitioner in conformity with the closing agreement. The portion of the "refund" allocable to 1935 was determined by taking 5287096/31878738 of $15,928.82.

Petitioner contends that the closing agreement was a compromise settlement of its Title III and Title VII controversies upon an aggregate, net basis and that no item in the accompanying schedule can be segregated and held to be a "refund" for the year 1935. It argues that the schedules became submerged into and were superseded by the written agreement; that it is the only competent evidence of the transaction; that it shows merely a payment of an additional amount of tax ($16,405.33) by petitioner; that no amount was ever "refunded" to it; and that even if a "refund" were actually made, it can not be allocated to the various years. We do not believe that any of these contentions are sound. All of the documents should be considered together. Collectively they show that petitioner was allowed a refund of $20,474.88, which, together with payment of $16,405.33, settled its tax on unjust enrichment under Title III. We think, therefore, that the only question to be considered is whether the refund in 1939 of the amount paid in 1935 as an unconstitutional tax should be determined to be income in the year of receipt, or restored to income for the year in which the deduction was taken.

[fol. 47] The question was recently discussed at length by this Board in E. B. Elliott Co., 45 B. T. A. 82, the majority

holding "that all refunds of paid taxes are to be adjusted to the years in which the taxes were paid and deductions claimed, as the best method to reflect income; the only proper departure from the rule of adjustment of the refund in the years of payment is where the statute of limitations or some other consideration has made it impossible. In such cases it is obviously inequitable to allow the taxpayer the unjust enrichment which would result and the refund must then be treated as income in the year of receipt." This is determinative of the present controversy. It may be added that, in view of the conclusion reached upon the first issue, it would be highly inequitable to the fiscus to deny the claimed adjustment. On the authority of the cited case this issue is resolved in favor of the respondent.

Reviewed by the Board.

Decision will be entered under Rule 50.

Smith, Kern, and Opper concur in the result on the authority of E. B. Elliott Co., 45 B. T. A. 82, as to both points.

Sternhagen, Van Fossan, Murdock, and Tyson dissent.

DISSENTING OPINION.

Arnold, dissenting: It seems to me that the majority stresses the exception contained in section 43 and ignores the general rule thereof regarding the taking of deductions. The general rule stated in that section, and repeatedly emphasized by the courts and this Board, is that "deductions * * * shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed * * *." Under the general rule the entire amount received from flour sales constituted gross income; with this the majority agrees. Under the general rule no deductions could have been taken in 1935 for liabilities that were not incurred, accrued, or paid until later years; with this the majority agrees. It is my opinion that when the majority reaches this point the issue has been decided and there is no justification for carrying back from 1936, [fol. 48] 1937, and 1938 deductions accrued in those years and not paid or accruable in 1935. Petitioner's 1935 income

will be clearly reflected by taking into account all items of income and deductions of that annual accounting period.

The majority opinion states that the identical question was before us in Cannon Valley Milling Co., 44 B. T. A. 763 (on appeal C. A. A., 8th Cir.), and on the authority of the cited case and for the reasons stated therein holds that the payments to vendees in 1936, 1937, and 1938 are deductible from 1935 income, although not accruable in that year. The cited case holds that amounts so paid were ordinary and necessary expenses of carrying on a trade or business; that section 43 was not meaningless and should be applied in proper cases; and that respondent could not by regulation limit the scope of section 43. That opinion further points out that few instances have arisen in which the courts or this Board have had occasion to consider section 43 and that the cases relied on by the parties litigant furnished but slight aid in determining the issue. It is important therefore to consider the intent of Congress in its enactment of the exception to the general rule contained in section 43.

The exception, as originally enacted by Congress, first appeared in the Revenue Act of 1921, which provided that losses should be deducted in the year "sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period." Sec. 234 (a) (4).

In the Revenue Act of 1924 Congress extended the exception to all deductions and credits. The exception appears in section 200 (d) of that act in identically the same language as it appears in section 43 of the Revenue Act of 1934. All intervening revenue acts and those enacted subsequent to the taxable year contain the exception in the same language.

In explaining the change made in the exception by the Revenue Act of 1924, the Committee on Ways and Means said: "The Revenue Act of 1921 * * * authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed [fol. 49] bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause

him to pay either more or less taxes than he properly should." (H. R. 179, 68th Cong., 1st sess., pp. 10, 11.) The report of the Senate Committee on Finance is to the same effect and in identical language (S. Rept. No. 398, 68th Cong., 1st sess., p. 10.)

According to the reports of the Ways and Means Committee and the Senate Finance Committee Congress intended, by the exception, to make provision for cases in which "a taxpayer pays in one year interest or rental payments or other items for a period of years." The payments made by this petitioner to its vendees were not interest payments in one year for a period of years; the payments were not rental payments made in one year for a period of years; nor were they payments in one year of other items for a period of years. As a matter of fact petitioner paid back in one year (1936, 1937, or 1938) a portion of the price of flour sold in 1935. No payments in one year for a period of years are involved in this proceeding and such payments as were made were not because of any obligation growing out of the sale itself, but primarily for the purpose of retaining the good will and the business of certain selected customers. Since the exception was designed by Congress to prevent the distortion of income which would result from deducting in one year the accumulated deductions of a period of years, I can see no reason to apply the exception to an entirely different situation, and under circumstances which violate one of the cardinal rules of income tax law, namely, that tax liability shall be determined on the basis of annual accounting periods.

Furthermore, it seems to me that the Commissioner's regulations for administering the exception are entitled to more weight and consideration than the majority has given thereto. By section 212 of the Revenue Act of 1924 and section 41 of the Revenue Acts of 1934 and 1936 Congress delegated to the Commissioner the power to deter- [fol. 50] mine whether the method of accounting employed by a taxpayer clearly reflects its income, and "if the method employed does not clearly reflect the income" the statutes provide that "the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income." Since a clear reflection of income requires a determination of the period in which

deductions and credits shall be taken, like discretion would seem by implication to be contained in section 43. 3 Paul & Mertens Law of Federal Income Taxation, p. 307.

Respondent's regulations have consistently construed section 43 and its prototypes, as a grant of discretion, in the exercise of which he would allow a deduction as of a different period only in exceptional circumstances. Art. 146, Regulations 62; art. 43-1, Regulations 86 and 94; T. D. 3261, I-1 C. B. 148. The regulations have always required a taxpayer to take the deduction in the year "paid or accrued" or "paid or incurred" and to submit with the return a complete statement of facts upon which it relies to take deductions as of a different taxable year. The Commissioner would then determine from such facts whether the taxpayer was entitled to the deduction for the period requested. The requirement in the regulation is in my opinion a reasonable one and imposes no hardship upon a taxpayer. The successive reenactment of the statutory provisions without alteration have imparted to the regulations the force and effect of law, Helvering v. Reynolds Tobacco Co., 306 U. S. 110, and unless petitioner has complied with the distinct method provided for in the regulations, it can not avail itself of the exception contained in section 43. Stokes v. United States, 19 Fed. Supp. 577, 580.

Assuming that the exception is applicable to the facts here, the record does not show that this petitioner made any effort to comply with the distinct method provided in the regulations for availing itself of the exception. In my opinion, the petitioner should have so complied if it expected the benefit of the statute. Even if petitioner had complied with the regulations, it is my opinion that the facts and circumstances here are not such as Congress had in mind when it created the exception to the general rule.

For the foregoing reasons I respectfully dissent from the opinion of the majority.

[fol. 51] BEFORE UNITED STATES BOARD OF TAX APPEALS

DECISION—December 29, 1941

Pursuant to the findings of fact and opinion of the Board promulgated November 12, 1941, the parties herein on December 24, 1941 having filed an agreed recomputation of tax, now, therefore, it is

Ordered and Decided: That there are deficiencies in excess-profits tax in the amount of $927.97 and income tax in the amount of $8,760.19 for the calendar year 1935.

Entered December 29, 1941.

Arthur J. Mellott, Member. (Seal.)

IN UNITED STATES CIRCUIT COURT OF APPEALS, TENTH CIRCUIT

PETITION FOR REVIEW, CASE NO. 2556—Filed March 26, 1942

Guy T. Helvering, United States Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Tenth Circuit to review the decision entered by the United States Board of Tax Appeals on December 29, 1941, ordering and deciding that there are deficiencies in Federal income and excess-profits taxes for the taxable year 1935 in the respective amounts of $8,760.19 and $927.97. This petition for review is filed pursuant to the provisions of Section 1141 and 1142 of the Internal Revenue Code.

The Security Flour Mills Company, a corporation organized and existing under and by virtue of the laws of the State of Kansas and having its principal office and place of business in Abilene, Kansas, respondent on review, filed its Federal income and excess-profits tax return for the calendar year 1935 with the Collector of Internal Revenue for the District of Kansas, whose office is located at Wichita, Kansas, and within the jurisdiction of the United States Circuit Court of Appeals for the Tenth Circuit.

J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue.

[File endorsement omitted.]

[fol. 52] IN UNITED STATES CIRCUIT COURT OF APPEALS

NOTICE OF FILING PETITION FOR REVIEW—Filed April 2, 1942

To: The Security Flour Mills Company, Abilene, Kansas.

You are hereby notified that the Commissioner of Internal Revenue did, on the 26th day of March, 1942, file with

the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Tenth Circuit of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review is hereto attached and served upon you.

Dated this 26th day of March, 1942.

J. P. Wenchel, RLW, Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 28 day of March, 1942.

The Security Flour Mills Company, by W. A. Chain, Secretary, Respondent on Review.

[File endorsement omitted.]

In United States Circuit Court of Appeals

Notice of Filing Petition for Review—Filed April 13, 1942

To: Robert C. Foulston, Esq., 608 Fourth National Bank Bldg., Wichita, Kansas.

You are hereby notified that the Commissioner of Internal Revenue did, on the 26th day of March, 1942, filed with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Tenth Circuit of the decision of the Board heretofore rendered in the above-[fol. 53] entitled cause. A copy of the petition for review is hereto attached and served upon you.

Dated this 26th day of March, 1942.

B. D. Gamble, Clerk, United States Board of Tax Appeals.

Service of the above and foregoing notice, together with a copy of the petition for review, is hereby acknowledged this 8th day of April, 1942.

Robert C. Foulston, Counsel for Respondent on Review.

[File endorsement omitted.]

In United States Circuit Court of Appeals

Statement of Points, Case No. 2556—Filed April 17, 1942

Comes now the petitioner on review herein and makes this concise Statement of Points on which he intends to rely on the review herein, to-wit:

The United States Board of Tax Appeals erred—

1. In ordering and deciding that there are deficiencies in income and excess profits taxes for the year 1935 in the respective amounts of only $8,760.19 and $927.97.

2. In failing and refusing to sustain that portion of the deficiencies claimed by the Commissioner which is attributable to the disallowance by him of the claimed deduction in 1935 of $45,865.90 for amounts repaid by the taxpayer to its vendees in 1936, 1937 and 1938.

3. In holding and deciding that the payments made by the taxpayer to its vendees in 1936, 1937 and 1938 in the aggregate amount of $45,865.90 in connection with the sale by the taxpayer to its vendees of wheat products processed and sold in 1935 were deductible from its gross income for the year 1935 in computing its net taxable income for 1935, under the provisions of Section 43 of the Revenue Act of 1934.

4. In failing and refusing to hold and decide that under Article 43-1 of Regulations 86 the taxpayer is not entitled [fol. 54] to the deductions claimed in the taxable year 1935 in the aggregate amount of $45,865.90 since the Commissioner has determined that the special treatment set forth under such article is not applicable in the instant proceeding where the claimed amounts were paid in subsequent years and no liability for such payments was admitted or conceded by the taxpayer during the year 1935.

5. In failing to hold and decide that since no obligation, express or implied, existed during the year 1935 to make reimbursement of any part of the taxpayer's gross sales for its taxable year 1935, the taxpayer is not entitled to deduct from its gross income for 1935 the reimbursements made by it to its vendees in later years.

6. In that its opinion and decision are contrary to its findings of fact.

7. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Statement of Service

A copy of this Statement of Points was mailed to Robert C. Foulston, Esq., 608 Fourth National Bank Building, Wichita, Kansas, attorney for respondent on review, this date, April 17, 1942.

Chas. E. Lowery, Special Attorney, Bureau of Internal Revenue.

[File endorsement omitted.]

Before United States Board of Tax Appeals

Designation of Contents of Record on Review, Case No. 2556—Filed April 17, 1942

To the Clerk of the United States Board of Tax Appeals:

Now Comes Guy T. Helvering, Commissioner of Internal Revenue, the petitioner on review herein, by and through his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for the purpose of the review which he, the said petitioner on review, has theretofore [fol. 55] taken to the United States Circuit Court of Appeals for the Tenth Circuit, hereby designates for inclusion in the record on review the following:

1. Docket entries of the proceedings before the Board.
2. Pleadings:
   (a) Amended and supplemental petition, including annexed copy of deficiency notice.
   (b) Answer to amended and supplemental petition.
   (c) Reply to answer to amended and supplemental petition.
3. Findings of fact and opinion promulgated November 12, 1941.
4. Decision.

5. Petition for review.
6. Notices of filing petition for review.
7. Statement of points.
8. This designation.

Wherefore, it is requested that copies of the record as above designated be prepared and transmitted to the United States Circuit Court of Appeals for the Tenth Circuit in accordance with the rules of said Court.

J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Statement of Service

A copy of this designation of contents of record on review was mailed to Robert C. Foulston, Esq., 608 Fourth National Bank Building, Wichita, Kansas, attorney for respondent on review this date, April 17, 1942.

Chas. E. Lowery, Special Attorney, Bureau of Internal Revenue.

[File endorsement omitted.]

[fol. 56] Clerk's Certificate to foregoing transcript omitted in printing.

In United States Circuit Court of Appeals

Petition for Appeal, Case No. 2589—Filed February 11, 1942

Your petitioner, conceiving itself aggrieved by the final decision and judgment of the United States Board of Tax Appeals made and entered on the 12 day of November, 1941, does hereby petition and pray that an appeal be allowed from said decision and judgment to the United States Circuit Court of Appeals for the Tenth Circuit as by law provided.

Your petitioner herein, The Security Flour Mills Company, a corporation organized and existing under and by virtue of the laws of the State of Kansas and having its principal office and place of business in Abilene, Kansas, respectfully shows to the Court and hereby states the fol-

lowing facts in connection with the appeal from said decision of the United States Board of Tax Appeals:

First: This is a proceeding for review by the United States Circuit Court of Appeals for the Tenth Circuit of a decision of the United States Board of Tax Appeals entered November 12, 1941, redetermining a deficiency in federal income taxes of the petitioner for the calendar year 1935 in the amount of Four Hundred Ninety Six and 73/100 Dollars ($496.73).

[fol. 57] Second: The petitioner's federal income tax return for the calendar year 1935 was filed with the Collector of Internal Revenue for the District of Kansas at Wichita, Kansas. On November 28, 1939, a hearing was held at Kansas City, Missouri, before The Honorable William W. Arnold, a member of the United States Board of Tax Appeals. The said United States Board of Tax Appeals promulgated its report and opinion on November 28, 1939. On November 12, 1941, the said United States Board of Tax Appeals entered its decision determining a deficiency in federal income taxes of the petitioner for the calendar year 1935 in the amount of Four Hundred Ninety Six and 73/100 Dollars ($496.73).

Your petitioner herein, The Security Flour Mills Company, a corporation, shows that the United States Circuit Court of Appeals for the Tenth Circuit has territorial jurisdiction of the adjudicated liability and controversy and that this petitioner requests a review of said decision and judgment by the United States Circuit Court of Appeals for the Tenth Circuit.

Third: The controversy between the petitioner and the respondent is the determination of federal income taxes of the petitioner for the calendar year 1935, and involves the following issues:

(1) Did the petitioner receive a refund of processing taxes from the Commissioner of Internal Revenue (as claimed by the respondent and so held by the Board of Tax Appeals) which were paid by the petitioner during the calendar year 1935?

(2) Assuming arguendo that the Commissioner of Internal Revenue refunded the processing taxes to the petitioner, did the petitioner receive such refund during the calendar year 1935?

Fourth: The facts relating to the issues may be briefly summarized as follows:

Following the invalidation of the Agricultural Adjustment Act on January 6, 1936, by the Supreme Court of the United States in the case of Butler v. U. S., 297 U. S. 1, Congress enacted Title III and Title VII of the Revenue [fol. 58] Act of 1936. Thereafter the petitioner filed a claim for refund of a portion of the processing taxes previously paid by it pursuant to the provisions of Title VII of said Act, said claim for refund being in the amount of *Six* One Thousand Seventy Two and 85/100 Dollars ($61,072.85). Petitioner likewise filed an unjust enrichment tax return pursuant to the provisions of Title III of said Act for the period ending December 31, 1935, showing no tax due. A similar return was filed for the period ending December 31, 1936.

On March 18, 1939, petitioner executed a closing agreement under Section 506 of the Revenue Act of 1936, under which agreement petitioner's liability for unjust enrichment taxes (Title III) were finally settled. By the provisions of said agreement petitioner paid Sixteen Thousand Four Hundred Five and 33/100 Dollars ($16,405.33) as unjust enrichment tax. Following the execution of the closing agreement petitioner received a notice and demand for tax in the amount stipulated in the closing agreement. Payment in full was made by petitioner of the taxes demanded, which were specified in the closing agreement.

Subsequent to the execution of the closing agreement the Commissioner reopened petitioner's income tax return for the fiscal year ended December 31, 1935. Following the reopening of the case, the Commissioner issued a deficiency notice of income tax for the year 1935. The basis for the asserted deficiency was claimed to be that the petitioner during the period ended December 31, 1935, had taken a deducation for processing taxes paid and that it had received a refund of such processing taxes under the closing agreement executed March 18, 1939.

Fifth: The errors committed by the Board of Tax Appeals, which are hereby assigned as the basis for this review, are as follows:

(1) The United States Board of Tax Appeals erred in affirming the determination of the Commissioner of Internal

Revenue of a deficiency in the 1935 income tax return of appellant.

(2) The decision and judgment of the United States Board of Tax Appeals is contrary to law and is contrary [fol. 59] to and is not supported by either the undisputed evidence herein or the findings of fact of said United States Board of Tax Appeals.

(3) Under the undisputed facts herein and under the United States Board of Tax Appeals' own findings of fact, the said Board erred in holding that the petitioner received a refund of processing taxes and in including such refund in the income of the petitioner for the fiscal year ended December 31, 1934.

(4) The United States Board of Tax Appeals erred in holding or basically assuming that the burden was upon petitioner affirmatively to establish that petitioner did not receive a refund of processing taxes paid during the year 1934.

(5) The United States Board of Tax Appeals erred in not giving final, controlling, and conclusive weight to the closing agreement (petitioner's Exhibit "1") entered into between petitioner and respondent.

(6) The United States Board of Tax Appeals found that the petitioner's title VII refund was $15,928.82 and interest thereon in the amount of $4,546.06, or a total of $20,474.88, which finding was unsupported by any evidence, and the Board erred in so finding.

(7) The Board erred as a matter of law in finding the processing tax refund was in the total amount of $20,474.88, and that the petitioner's unjust enrichment tax under Title III of the Revenue Act of 1936 was $36,880.21.

(8) The Board's finding that the petitioner's Title III unjust enrichment tax of $36,880.21 was unsupported by any evidence, and the verdict erred in so finding.

(9) The Board in finding that the petitioner received a refund of $20,474.88, including interest, disregarded all the positive and affirmative evidence submitted by petitioner with respect to the payment of its Title III tax.

(10) The Board erred in holding and deciding that an alleged refund of $20,474.88 should be included in the tax-

able income of petitioner for the year ending December 31, 1935.

[fol. 60] (11) The Board erred in holding that there is a deficiency in income tax of $496.73 due from the petitioner for the calender year 1935.

Your petitioner herein, The Security Flour Mills Company, a corporation, shows that the United States Circuit Court of Appeals for the Tenth Circuit has territorial jurisdiction of the adjudicated liability and controversy and that this petitioner requests a review of said decision and judgment by the United States Circuit Court of Appeals for the Tenth Circuit.

Wherefore, the petitioner herein prays that This Honorable Court review the decision of the United States Board of Tax Appeals entered November 12, 1941, and reverse said decision as not being in accordance with law and direct the entry of a decision by the United States Board of Tax Appeals determining that there is no deficiency in federal income taxes of the petitioner for the calendar year 1935, and for such other and further relief as may to this Court appear proper in the premises.

Robert C. Foulston, 608 Fourth National Bank Building, Wichita, Kansas.

[Verification omitted.]

[File endorsement omitted.]

IN UNITED STATES CIRCUIT COURT OF APPEALS

NOTICE OF FILING PETITION FOR REVIEW—Filed Feb. 12, 1942

To: J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

You are hereby notified that The Security Flour Mills Company did, on the 11th day of February, 1942, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Tenth Circuit, of the decision of the Board heretofore rendered in the above

[fol. 61] entitled case. Copy of the petition for review as filed is hereto attached and served upon you.

Dated this 11th day of February, 1942.

B. D. Gamble, Clerk, U. S. Board of Tax Appeals.

Service of copy of Petition for Review acknowledged this 12th day of February, 1942.

J. P. Wenchel, Attorney for Respondent.

[File endorsement omitted.]

BEFORE UNITED STATES BOARD OF TAX APPEALS

DESIGNATION OF CONTENTS OF RECORD ON REVIEW, CASE NO. 2589—FILED JUNE 2, 1942

To the Clerk of the United States Board of Tax Appeals:

Now Comes The Security Flour Mills Company, petitioner on review herein, by and through its attorney, Robert C. Foulston, and for the purpose of the review which it, the said petitioner on review, has heretofore taken to the United States Circuit Court of Appeals for the Tenth Circuit, hereby designates for the inclusion in the record on review the following:

1. Docket entries of the proceedings before the Board.
2. Pleading:

(a) Amended and supplemental petition, including annexed copy of deficiency notice,

(b) Answer to amended and supplemental petition,

(c) Reply to answer to amended and supplemental petition.

3. Findings of fact and opinion promulgated November 12, 1941.
4. Decision.
5. Petition for review.
6. Notices of filing petition for review.
7. Statement of points.

[fol. 62] 8. This designation.

Wherefore, it is requested that copies of the record as above designated be prepared and transmitted to the

United States Circuit Court of Appeals for the Tenth Circuit in accordance with the rules of said Court:

Robert C. Foulston, 608 Fourth National Bank Bldg., Wichita, Kansas. Attorney for The Security Flour Mills Company, Petitioner on Review.

IN UNITED STATES CIRCUIT COURT OF APPEALS

ORDER ENLARGING TIME IN WHICH TO FILE TRANSCRIPT OF RECORD, CASE NO. 2589—Filed May 28, 1942

Now, to-wit, on this, the 25th day of May, 1942, it is this day ordered that for good cause shown the time within which said The Security Flour Mills Company, petitioner on review herein, may docket said case and file a transcript of the record here in this court, be and the same is hereby extended to and including June 10, 1942.

Orie L. Phillips, Judge of the United States Circuit Court of Appeals for the Tenth Circuit.

Now, July 2, 1942, the foregoing is certified from the record as a true copy.

B. D. Gamble, Clerk, U. S. Board of Tax Appeals. (Seal.)

[File endorsement omitted.]

[fol. 63] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 64] IN UNITED STATES CIRCUIT COURT OF APPEALS, TENTH CIRCUIT

ORDER OF SUBMISSION—January 18, 1943

First Day, January Term, Monday, January 18th, A. D. 1943. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

These causes came on to be heard and were argued by counsel, Robert C. Foulston, Esquire, and John F. Eberhardt, Esquire, appearing for The Security Flour Mills Company, Fred Youngman, Esquire, appearing for Commissioner of Internal Revenue.

Thereupon these causes were submitted to the court.

IN UNITED STATES CIRCUIT COURT OF APPEALS

OPINION—March 6, 1943

Fred Youngman (Samuel O. Clark, Jr., Ass't Attorney General, Sewall Key and Benjamin M. Brodsky, Special Ass'ts to the Attorney General, were with him on the brief) for Commissioner of Internal Revenue.

Robert C. Foulston and John F. Eberhardt (George Siefkin was with them on the brief) for The Security Flour Mills Company.

Before Phillips, Bratton and Huxman, Circuit Judges.

BRATTON, Circuit Judge:

This proceeding presents questions relating to income and excess profits taxes. The taxpayer was engaged in the manufacture and sale of flour, and was subject to the processing tax levied under the Agricultural Adjustment Act of 1933, 48 Stat. 31, 7 U.S.C.A. §601 et seq. During the period which is material here more than half of its sales of flour were made under the Miller's Federation Uniform Sales Contract. The sales were at a stated price per barrel which included the usual items of cost, a normal profit, and a sufficient amount to cover the processing tax. The invoices reflected the contract price but did not show the tax [fol. 65] as a separate item. The taxpayer secured a temporary injunction, effective from May 1, 1935, restraining the further collection of the tax, on condition that it file informational returns and deposit in a designated bank a sum equal to the amount of the tax, computed according to the act. Up to December 1, 1935, the taxpayer deposited in the bank sums aggregating $93,974.40; and it accrued on its books as a liability for the processing tax, but did not pay either to the collector or the depository, the sum of $9,896.66, plus the additional item of $1,183.64, representing a reserve

for possible increases in the tax for prior years. In January, 1936, the processing tax provisions in the act were held invalid, United States v. Butler, 297 U. S. 1; and in February, thereafter, the sum deposited in the bank was returned to the taxpayer. Certain vendees of flour sought to intervene in the injunction proceeding and assert rights in the impounded funds, but the taxpayer resisted and the petitions were denied. After the impounded funds had been returned to the taxpayer, certain vendees instituted suits against it to recover amounts equal to the processing tax on flour purchased while the injunction was in force, but the taxpayer defended and the actions were finally dismissed. In 1936, the taxpayer credited the money which the bank returned to it to an account on its books designated "Reserve for Processing Tax, Claims, etc." The account bears credits aggregating $105,254.70, and debits of an equal amount, the last debit being a transfer to surplus of $30,289.99, made in June, 1939. In 1936, 1937, and 1938, the taxpayer disbursed to certain of its vendees on shipments of flour made while the injunction was in effect sums aggregating $45,865.90. No refunds were made to the other purchasers during that period. The taxpayer kept its books and made its tax returns on the accrual basis. In its return for 1935, it made deductions which included the funds impounded in the depository and the funds accrued on its books as processing taxes but not impounded or paid to the collector. The Commissioner disallowed the deductions of these items. The Board of Tax Appeals ruled that the sums which the taxpayer received from its vendees to cover the processing tax constituted gross income for the year 1935, and that the amounts disbursed in 1936, 1937, and 1938, should be carried back and allowed as deductions for the year 1935. The Commissioner sought review from [fol. 66] that part of the decision allowing the deductions in that manner.

Like all other revenue acts enacted since the adoption of the Sixteenth Amendment, the Act of 1934, 48 Stat 680, assessed the taxes on the basis of annual periods, either the calendar year, or, at the election of the taxpayer, a fiscal year; and section 23(a) authorized the deduction from gross income of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

The production of revenue ascertainable and payable at fixed intervals is the essence of any feasible system of taxation. It is the essence itself of any general scheme for taxing income as a means of producing a regular flow of income. Burnet v. Sanford & Brooks Co., 282 U. S. 359. Where accounts are kept and returns made on the accrual basis, income is to be accounted for in the year in which it is realized, even though not actually received; and deductions are to be taken in the year in which the items deducted are incurred, whether actually paid or not. Brown v. Helvering, 291 U. S. 193. Revenue received under claim of right without restriction in respect of its use or disposition constitutes taxable income, even though the one receiving it may thereafter be adjudged liable to restore it or its equivalent: North American Oil v. Burnet, 286 U. S. 417; Brown v. Helvering, supra; Saunders v. Commissioner, 101 F. (2d) 407; London-Butte Gold Mines Co. v. Commissioner, 116 F. (2d) 478. And ordinarily where the accrual system is used in keeping books of account and making income tax returns, deductions may be claimed for the year the accrual of liability occurred, or not at all, even though the transaction or transactions giving rise to the accrual of liability may have taken place in an earlier year. Lucas v. Ox Fibre Brush Co., 281 U. S. 115. Losses suffered or expenses accrued in a later year may be deducted from earnings in that year. But the tax on the income of a given year may not be withheld or diminished because losses may subsequently occur or expenses be later accrued. Heiner v. Mellon, 304 U. S. 271.

Here the taxpayer received from its vendees amounts equal to the processing tax on flour sold during the period in which the injunction was in force. It made no promise [fol. 67] or contractual obligation to repay or refund any or all thereof in the event the act was declared unconstitutional, or otherwise. It stated to some purchasers of flour that it would treat them fairly, but it carefully and painstakingly avoided making any binding commitment to restore to them any of the fund or its equivalent. It was not legally liable to them for any of it, Moundridge Milling Co. v. Cream of Wheat Corp., 105 F. (2d) 366; and after the declared invalidity of the processing tax statute, it bore no liability to the fiscus for any part of such fund, Rickert Rice Mills v. Fontenot, 297 U. S. 110. But it became entitled to the money and actually received it in 1935 under

claim of right without legal restriction as to its use and disposition, and it therefore constituted taxable income in that year. North American Oil v. Burnet, supra; Brown v. Helvering, supra; Saunders v. Commissioner, supra.

Section 43 of the revenue act, supra, is relied upon as authorizing the relation back of the amounts disbursed to the year 1935. The pertinent part of the section provides that "deductions and credits * * * shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." A substantially identical provision first appeared as section 200(d) of the Revenue Act of 1924, and is to be found in all later revenue acts. In explaining the provision in the Act of 1924, the report of the Committee on Ways and Means of the House stated:

> "The Revenue Act of 1921 * * * authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should."

[fol. 68] The report of the Senate Committee on Finance was identical. These reports make it clear that the legislative intent and purpose of the "unless" provision was to authorize the exception to the general rule in cases in which the taxpayer pays in one year interest, or rental, or other items for a period of years, and to other instances of that character, in order to prevent distortion of income of the taxpayer. It is manifest that Congress had in mind for application of the provision only instances in which a taxpayer receives income or makes expenditures in one year which are attributable to or related to business operations extending over a number of years. The distortion in income sought to be avoided is that which would result from charging a taxpayer with income received in a single year

but in fact earned over a period of years, or permitting him to take in one year deductions actually attributable to operations extending through two or more years. To permit that would not fairly reflect annual income. Instead it would amount to distortion of income. The provision comes into operative play in instances of that kind. It was never intended to go beyond that scope. These transactions were not of that kind. All of the income was fully earned in 1935. No part of it extended over a period of years. The expenditures were not for interest, or rental, or other items of that kind covering a period of years. They were not in liquidation of any previously accrued legal obligation. They were voluntarily made for the primary purpose of retaining the good will of customers; and the liability was accrued and discharged, all after 1935. In short, neither the income nor the respective disbursements were attributable to operations extending over two or more years. Instead each was effected and completed in a single year. For these reasons the taxpayer does not bring itself within the "unless" clause in the statute. The amounts disbursed were deductible from gross income in 1936, 1937, and 1938, respectively; but not from that of 1935. North American Oil v. Burnet, supra.

The taxpayer places strong reliance on Helvering v. Cannon Valley Milling Co., 129 F. (2d) 642. Assuming for the moment that disbursements of this kind may be related back in certain circumstances, though we think otherwise, the two cases are distinguishable. There apparently all the facts were before the court, and it was held that unless [fol. 69] the disbursements were related back income would be distorted with resulting injustice to the taxpayer. Here the return of the taxpayer for 1937 disclosed a net loss, computed by including in the deductions claimed a sum representing the amounts paid in that year to vendees of flour. But the returns for 1936 and 1938 were not introduced in evidence, and there was no showing whatever in respect of gross or net income for those years. Therefore, considering 1935, 1936, 1937, and 1938, together, as they should be considered, there is no basis for the conclusion that the deductions must be related back in order to clearly reflect the income and deductions, and to prevent distortion of income, within the meaning of the statute.

Title III of the Revenue Act of 1936, 49 Stat. 1648, imposes a tax on unjust enrichment arising out of the nonpayment of processing taxes, the burden of which has been shifted to others; and Title VII authorizes refunds for amounts paid as processing taxes. Section 506 of Title III provides that one who is liable for unjust enrichment taxes and who also has a claim for an amount paid as processing taxes may apply to the Commissioner for an adjustment of the two together; that the Commissioner may in his discretion consider them in that manner; that he may enter into a written agreement with the person for the settlement of the case by payment or refund as may be specified in the agreement; and that the agreement shall be a final settlement of the liability for taxes and of the claim for refund, except in cases of fraud, malfeasance, or misrepresentation of material fact. The taxpayer filed a claim for refund of amounts paid as processing taxes before the date on which the injunction became effective. The Commissioner and the taxpayer proceeded under section 506 and reached a settlement of the liability for unjust enrichment taxes and of the claim for refund. The signed agreement provided that the whole matter should be finally settled by the taxpayer making payment of $16,405.33, and that amount was paid. The Board found that the computation made in connection with the agreement disclosed a net unjust enrichment tax liability for 1935, 1936, and 1937 of $36,880.21, a refund of $20,474.88, and a net tax payable of $16,405.33, of which $2,649.25 pertained to a refund of processing taxes for 1935, and was allowed by the Commissioner in determining the deficiency. The Board concluded that such sum [fol. 70] should be restored to income for the year 1935; and the taxpayer perfected a separate appeal from that part of the decision.

The question calls for little discussion. Section 506 is a clear mandate that an agreement entered into under its provisions shall be and constitute a final settlement of the liability for the tax and of the claim for refund, unless there was fraud, malfeasance or misrepresentation of a material fact in connection with its execution. There is no suggestion that any lack of good faith occurred in connection with the execution of this agreement. The contract was a final settlement. And in view of the plain language of the statute, we fail to see any warrant for going behind it and

restoring to income for 1935 any item or sum which was taken into consideration in reaching the settlement.

The order is reversed and the proceeding remanded to the Board.

DISSENTING OPINION

PHILLIPS, Circuit Judge, dissenting:

The Security Flour Mills Company will be referred to as the taxpayer. The taxpayer kept its books on an accrual basis.

Sec. 23 of the Revenue Act of 1934 in part provides:

> "In computing net income there shall be allowed as deductions: * * *
>
> "Taxes paid or accrued within the taxable year, * * *."

The question presented is not whether the entire amount received from sales of flour by the taxpayer, including the amount embraced in the composite price to cover processing taxes, was income to the taxpayer in 1935. Manifestly it was. We are concerned rather with a deduction of taxes accrued under an unconstitutional statute, the validity of which was not determined until a subsequent year; and the deduction of amounts returned by the taxpayer to its purchasers.

While it has been held that an unconstitutional statute is void ab initio,[1] the rule is not without certain qualifica- [fol. 71] tions. In Chicot C. Drainage District v. Baxter State Bank, 308 U. S. 371, 374, the court said:

> "It is quite clear, however, that such broad statements as to the effect of a determination of unconstitutionality must be taken with qualifications. The actual existence of a statute, prior to such a determination, is an operative fact and may have consequences which cannot justly be ignored. The past cannot always be erased by a new judicial declaration. The effect of the subsequent ruling as to invalidity may have to be considered in various aspects,—with respect to particular relations, individual and corpo-

[1] Norton v. Shelby County, 118 U. S. 425, 442; Chicago, Indianapolis & L. Ry. Co. v. Hackett, 228 U. S. 559, 566.

rate, and particular conduct, private and official. Questions of rights claimed to have become vested, of status, of prior determinations deemed to have finality and acted upon accordingly, of public policy in the light of the nature both of the statute and of its previous application, demand examination."

See, also, Phipps v. School District of Pittsburgh, 3 Cir., 111 F. 2d 393, 395.

The taxpayer here certainly was under compulsion while the validity of the Agricultural Adjustment Act remained undetermined to accrue the tax liability and provide funds for its discharge throughout the entire year of 1935.

I, therefore, conclude that the taxpayer, in its income tax return for 1935, had the right to deduct as taxes accrued in 1935, the $93,974.40 which it accrued on its books for processing tax liability for the period May 1, to November 30, 1935, and paid to the depository, and the $9,896.66 which it accrued on its books, for processing tax liability for December, 1935, but did not pay to the depository. This view is supported by Davies' Estate v. Commissioner, 6 Cir., 126 F. 2d 294, c. d. Oct. 12, 1942, —— U. S. ——, 63 S. Ct. 32, and J. A. Dougherty's Sons, Inc., v. Commissioner, 3 Cir., 121 F. 2d 700.

Therefore, when on January 6, 1936, the Agricultural Adjustment Act was declared unconstitutional in United States v. Butler, 297 U. S. 1, it became the duty of the taxpayer to accrue on its books as income for 1936, the $93,974.40 in the hands of the depository and the $9,896.66 ac- [fol. 72] crued for processing taxes for December, 1935. See Nash v. Commissioner, 7 Cir., 88 F. 2d 477.

It has been held, however, that the Commissioner may cancel a deduction taken in one year for a tax which the taxpayer has accrued or paid, when the tax has been refunded in a later year because it was unlawfully imposed.[2]

However, if what occurred in 1936 is to be related back to 1935, then it would seem that the payments made to cus-

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[2] See Ben Bimberg & Co. v. Helvering, 2 Cir., 126 F. 2d 412, 413;
Inland Products Co. v. Blair, 4 Cir., 31 F. 2d 867;
Leach v. Commissioner, 1 Cir., 50 F. 2d 371;
Bergan v. Commissioner, 2 Cir., 80 F. 2d 89.

tomers by the taxpayer in 1936, 1937, and 1938 should likewise be related back to 1935, under the provisions of Sec. 43 of the Revenue Act of 1934, 48 Stat. 694.[3] Otherwise, the actual income of the taxpayer for 1935 will not be clearly reflected.

I cannot agree that the broad language of the "unless" provision in Section 43 should be narrowly limited to cases where "the taxpayer pays in one year interest or rental or other items for a period of years." The provision is couched in general terms and it contains nothing to indicate that its meaning was to be so limited. Rather, it justifies the interpretation that it is intended to apply to all deductions where its application is necessary to truly reflect the income.

Throughout the calendar year 1935, the taxpayer, from a realistic point of view, was under compulsion to regard the Act as subjecting it to a tax of $1.38 per barrel of flour processed. The selling price consisted of the usual items of cost, plus a normal profit, and included, in addition, an amount sufficient to cover the processing tax. The result was that the taxpayer's apparent gross income for 1935 was enhanced by approximately $100,000. This unnatural increment to gross earnings was due entirely to invalid processing taxes. As of December 31, 1935, it was offset [fol. 73] by an accrued liability for processing taxes. However, on January 6, 1936, the Agricultural Adjustment Act was adjudicated unconstitutional and the taxpayer's processing tax liability was absolved. Thereupon, business necessity required that the taxpayer reimburse its vendees for taxes collected from them as a part of the sale price of flour if it could do so and not become liable for unjust enrichment taxes thereon. In 1936, 1937, and 1938, after the taxpayer had obtained a ruling on its unjust enrichment liability from the Treasury, it repaid to its vendees, $45,-

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[3] Section 43 of the Revenue Act of 1934, 48 Stat. 694, in part reads:

> "The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period * * *"

865.90, in compromise of claims asserted by such vendees. Obviously, these payments had absolutely no relation to the cost of earning income in the years of payment. Equally apparent is the fact that they had direct relation to the taxpayer's 1935 gross income. They represented refunds to vendees of amounts paid to the taxpayer in 1935 as a part of the sale price of flour because of the processing tax. They, in fact, resulted in a reduction of taxpayer's gross income from 1935 sales. Only by relating them to the year 1935 can the income for that year be truly reflected. It seems to me that it was to relieve against just such a situation that Section 43 was enacted. The following from the opinion of the Eighth Circuit, in Helvering v. Cannon V. M. Co., 129 F. 2d 642, 646, is apposite:

> "*Application.* In the months of May and June, 1935, this taxpayer collected the processing tax as a part of its sales prices. In its tax return for that year, the amount of such collections was included in its gross income and was entirely offset by a claimed tax deduction. The result was that the collections had no effect upon its net income. Three years later, the Commissioner redetermined the tax by disallowing the deduction. Since this disallowance left the gross income (which included the collections) undisturbed, the result would be that the net income would be increased by the amount of the collections. It was not until 1936 that the contingency (validity vel non of the A. A. Act) was resolved and the right of taxpayer to the accrued income from the collections was determined. Therefore, the disallowance by the Commissioner was a relation back to the tax year 1935 of an accrual which had become fixed in a later year. At the time of the redetermination, it was established that only a part of the [fol. 74] collections had remained the property of the taxpayer and a part of its income. All that taxpayer seeks is to have related back from 1937, the disbursements which reduced the collections in order that its net income for 1935 will be 'clearly' and truly stated. Both the deduction and the reimbursements relate to the same transactions in 1935. Clearly, to disallow the deduction and to refuse the decrease thereof by the reimbursements will distort the taxable income for that year. To permit the Commissioner to open up the item

of deduction only to the extent it serves his purposes and to deny the taxpayer the effect of the reimbursements affecting the same item resulting in its paying a higher tax than it justly owes is an injustice to the taxpayer."

With respect to the second issue determined by the Board, for like reasons it seems to me the item of $2,649.25 should be treated as income in 1935. I do not think the closing agreement precludes an examination of the factual situation upon which it was predicated.

One subsidiary question remains: Noncompliance by the taxpayer with Art. 43 (1), Tr. Reg. 86, promulgated under the Revenue Act of 1934. In the first place, there was no occasion for the taxpayer to claim in its subsequent returns the deductions which it had taken in its 1935 return. In the second place, the rulings of the Commissioner fairly indicate that it would have been futile for the taxpayer to have claimed the deductions in its subsequent returns as of the year 1935. Finally, the issue was not raised at the hearing before the Board and that precludes its consideration here.[4] The case does not fall within the exception recognized in Hormel v. Helvering, 312 U. S. 552, and Helvering v Richter, 312 U. S. 561.

For the reasons indicated I think the decision of the Board should be Affirmed.

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[4] New Amsterdam Cas. Co. v. Farmers Co-Op. Union, 8 Cir., 2 F. 2d 214, 218;
New York Life Ins. Co. v. Doerksen, 10 Cir., 75 F. 2d 96, 101;
American Home Fire Assur. Co. v. Hargrove, 10 Cir., 109 F. 2d 86, 87;
Liberty Petroleum Co. v. California Co., 10 Cir., 114 F. 2d 980, 981.

[fols. 75-83] IN UNITED STATES CIRCUIT COURT OF APPEALS

JUDGMENT, CASE NO. 2556—March 6, 1943

Seventeenth Day, January Term, Saturday, March 6th, A. D. 1943. Before Honorable Orie L. Phillips, Circuit Judge, and Honorable J. Foster Symes, District Judge.

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said United States Board of Tax Appeals in this cause be and the same is hereby reversed; that this cause be and the same is hereby remanded to The Tax Court of the United States for further proceedings in accordance with the views expressed in the opinion of the court; and that Commissioner of Internal Revenue, petitioner, have and recover of and from The Security Flour Mills Company, respondent, his costs herein and have execution therefor.

IN UNITED STATES CIRCUIT COURT OF APPEALS

JUDGMENT, CASE NO. 2589—March 6, 1943

Seventeenth Day, January Term, Saturday, March 6th, A. D. 1943. Before Honorable Orie L. Phillips, Circuit Judge, and Honorable J. Foster Symes, District Judge.

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said United States Board of Tax Appeals in this cause be and the same is hereby reversed; and that this cause be and the same is hereby remanded to The Tax Court of the United States for further proceedings in accordance with the views expressed in the opinion of the court.

Petition for rehearing, covering 7 pages, filed May 22, 1943, omitted from this print. It was denied, and nothing more by order of May 22, 1943.

[fol. 84] IN UNITED STATES CIRCUIT COURT OF APPEALS

ORDER DENYING PETITION FOR REHEARING—May 22, 1943

Thirty-first Day, March Term, Saturday, May 22nd, A. D. 1943. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

The Security Flour Mills Company having heretofore filed a petition for rehearing in the above entitled causes and having been requested by the court to eliminate certain remarks in such petition for rehearing, and having presented a new petition for rehearing.

It is now here ordered by the court that said new petition for rehearing be and the same is hereby filed instanter, which is accordingly done. It is further ordered by the court that the petition for rehearing in these causes be and the same is hereby denied.

IN UNITED STATES CIRCUIT COURT OF APPEALS

ORDER RE ISSUANCE OF MANDATES

On June 2, 1943, the mandates of the United States Circuit Court of Appeals, in accordance with the opinion and judgments of said court, were issued to The Tax Court of the United States.

[fol. 85] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 86] UNITED STATES CIRCUIT COURT OF APPEALS, TENTH CIRCUIT

CLERK'S CERTIFICATE RE FILING OF PETITION FOR REHEARING

I, Robert B. Cartwright, Clerk of the United States Circuit Court of Appeals for the Tenth Circuit, do hereby certify that in case No. 2556, Commissioner of Internal Revenue vs. Security Flour Mills Company, a petition for rehearing was filed in this court on April 5, 1943, which was within the thirty days from March 6, 1943, the date of the judg-

ment of this court, for the filing of a petition for rehearing. A substituted petition for rehearing was filed May 22, 1943, by leave of court.

In testimony whereof, I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Tenth Circuit, at my office in Denver, Colorado, this 30th day of August, A. D. 1943.

Robert B. Cartwright, Clerk of the United States Circuit Court of Appeals, Tenth Circuit. (Seal.)

[fol. 87] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed October 11, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Tenth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Endorsed on cover: File No. 47,769. U. S. Circuit Court of Appeals, Tenth Circuit, Term No. 276. The Security Flour Mills Company, Petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed August 21, 1943. Term No. 276, O. T., 1943.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

ROBERT C. FOULSTON,
Counsel for Petitioner.

GEORGE SIEFKIN,
JOHN F. EBERHARDT,
Of Counsel.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI.

MAY IT PLEASE THE COURT:

Your petitioner, The Security Flour Mills Company, prays that a writ of certiorari issue to review the judgment entered March 6, 1943, and the judgment entered May 22, 1943, denying petition for rehearing of said original March 6, 1943, judgment, both said judgments being entered in the United States Circuit Court of Appeals for the Tenth Circuit in the above entitled cause.

A.

Questions Presented.

During the calendar year 1935, petitioner, a wheat flour processor then subject to the Agricultural Adjustment Act, sold flour at a price which included cost, normal profit, and

an amount sufficient to cover the processing tax. In 1936 the A. A. A. was adjudged unconstitutional. In 1936, 1937, and 1938, petitioner paid $45,865.90 to vendees who had purchased flour in 1935, to reimburse them for the processing taxes included in 1935 flour sales prices, which taxes petitioner had not paid over to the fiscus. *Issue:* Whether Section 43 of the 1934 Revenue Act permits the deduction of said $45,865.90 from 1935 gross income in order clearly to reflect petitioner's income for that year.

Three other issues not now material, but which petitioner intends to urge in event its petition is granted, are: (1) Whether the increment to 1935 flour sales prices represented by the charge for processing taxes then due, which increment was impounded by court order during pendency of injunction proceedings instituted to test the A. A. A.'s constitutionality, was set apart in a special suspense account upon adjudication of the tax's unconstitutionality, and was never accepted or treated by petitioner as income until 1937 when controversies concerning such fund, with vendees and with the fiscus under Titles III and VII of the 1936 Revenue Act, were resolved, is, save for that portion thereof ultimately retained by petitioner, includable in petitioner's 1935 gross income; (2) Whether the normal method of computing income as of annual accounting periods should not be departed from where the increment to petitioner's income from 1935 flour sales, by reason of the inclusion of processing taxes in sales prices, and the corresponding, subsequent vendee reimbursements, were both part of one enormous, extraordinary, sui generis, nonrecurring transaction; and (3) Whether a deduction for accrued tax liabilities, taken and allowed in 1935, may be disallowed subsequently when the taxing statute is declared unconstitutional and actual payment of such accrued tax liability is therefore never made by the taxpayer.

B.

Statute Involved.

Revenue Act of 1934, Section 43 (May 10, 1934, C. 277), 48 Stat. 694, 26 U. S. C. A. § 43:

> "Sec. 43. Period for Which Deductions and Credits Taken.
>
> The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, *unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.* * * *" (Emphasis supplied.)

C.

Summary Statement.

Petitioner, a Kansas corporation (R. 34), is engaged in manufacturing and selling wheat flour (R. 34). As such it was subject to the Agricultural Adjustment Act (R. 35).

During the calendar year 1935, petitioner sold flour at prices which consisted of the usual items of cost, plus normal profit, and included in addition an amount sufficient to cover the processing tax (R. 36). Due to pendency of an injunction suit instituted to test the constitutionality of the Agricultural Adjustment Act, petitioner paid no processing taxes to the fiscus subsequent to May 1, 1935 (R. 35). Instead, the amount of processing taxes "due" was impounded in a court designated depository from May through November, and was accrued on petitioner's books during December (R. 35).

At close of petitioner's 1935 calendar year, accrued liability for processing taxes amounted to $105,054.70 (R. 35). This sum (approximately) was deducted from 1935 income in petitioner's tax return for that year (R. 39-40).

During 1936 the taxing act was adjudged unconstitutional (R. 35). As a consequence, petitioner refunded $2,475.03 to its vendees in 1936, $41,879.50 in 1937, and $1,511.37 in 1938 (R. 36, 38-39)—a total refund of $45,865.90 (R. 34, 36, 38-39). These refunds were made with respect to 1935 sales, in order to reimburse vendees for processing taxes which they had paid as part of the sales price for flour purchased in 1935, which taxes petitioner had not paid over to the fiscus (R. 33, syl. 1 of B. T. A. opinion; R. 34, 39, 40, 45).

The Commissioner disallowed the $105,054.70 deduction in petitioner's 1935 tax return for processing tax liability accrued as of December 13, 1935, but subsequently dissolved (R. 40). The Commissioner refused to allow a deduction in lieu thereof for the $45,879.50 customer reimbursements actually paid, and on June 21, 1937, assessed an income tax deficiency of $14,702.48 and an excess-profits tax liability of $3,088.80 (R. 20, 34).

Whereupon petitioner, on August 9, 1937 (R. 5), petitioned the Board of Tax Appeals for a redetermination of said deficiency (R. 7).

It should be noted that in an amended answer filed with the Board, the Commissioner asserted a claim for an increased deficiency based upon a tax refund which was alleged to have been granted petitioner (R. 28-31; R. 34). The issue with respect to this additional deficiency was separately passed on by the Board (R. 45-47).

On this one issue, the Board's decision upheld the Commissioner (R. 45-47). In instituting an appeal to the Tenth Circuit Court of Appeals, docketed as appeal number 2556 (R. 53), the Commissioner specifically omitted this issue (R. 53-56). Present petitioner then filed a separate appeal, docketed number 2589 (R. 56), therefrom. In its opinion of

March 6, 1943, the Circuit Court of Appeals reversed the Board of Tax Appeals on this issue (R. 69-70), separate judgment being rendered thereon (R. 75).

Petition for rehearing filed with the Circuit Court by present petitioner was confined to appeal number 2556 and the judgment therein rendered (R. 77, 78-83). No petition for rehearing was filed in appeal number 2589, no petition for writ of certiorari was perfected within three months from date of that judgment, and said judgment is now final. Therefore no consideration will be given in this petition to the issues determined in appeal number 2589.

D.

Rulings of the Courts Below.

Opinion of the Board of Tax Appeals was rendered November 12, 1941 (R. 33). Observing that the identical question was involved in *Cannon Valley Milling Co.*, 44 B. T. A. 763 (1941), and that no substantial factual differences existed between the two cases (R. 45, lines 1-2 and 23-25), the Board held that reimbursements paid by petitioner to vendees in 1936-1937-1938 related to 1935 sales (R. 45, lines 21-22), and, under Section 43 (R. 45, line 16), should be deducted from 1935 gross income (R. 45, lines 31-33). No extended discussion was made, the Cannon decision being incorporated by reference: "On the authority of the cited case and for the reasons stated therein, we hold * * *" (R. 45, lines 29-31). Under Rule 50, formal decision was entered on the opinion December 29, 1941 (R. 51).

The Circuit Court of Appeals for the Tenth Circuit reversed this decision (R. 70). Relying upon Congressional committee reports (R. 67-68), the Circuit Court held Section 43 applies only where income or expenditures in one year relate to business operations *extending over a number of years* (R. 68, lines 8-12). No attempt was made to deny

the contrary legal conclusion of the Cannon case as affirmed on appeal by the Eighth Circuit (129 F. (2d) 642, 1942), but assuming its correctness *arguendo* (R. 68, lines 39-41) the court distinguished it upon the factual ground that there tax returns for 1935, 1936, 1937, and 1938 were in evidence, whereas here only the 1935 and 1937 returns were introduced (R. 68-69). The opinion was filed March 6, 1943 (R. 64). Judgment was entered the same day (R. 75). Petition for rehearing was filed May 22, 1943 (R. 83), in lieu of erroneous petition theretofore filed (R. 84), and memorandum order of denial was rendered May 22, 1943 (R. 84).

E.

Reasons for Granting Writ.

In the instant case, the Tenth Circuit Court of Appeals has decided an important question of Federal law—construction of Section 43 of the 1934 Revenue Act—which has not been, but should be, settled by this Court. In doing so, it has rendered a decision in direct conflict with the decision of the Eighth Circuit Court of Appeals on the same matter in *Helvering* v. *Cannon Valley Milling Co.*, 129 F. (2d) 642 (C. C. A. 8, 1942) affirming 44 B. T. A. 703 (1941).

Section 43 of the Revenue Act of 1934 first appeared as Section 200 (d) of the 1924 Revenue Act; it has been reenacted as Section 43 of each subsequent Revenue Act. It modifies the former rule that deductions may be taken only for the taxable year in which paid, accrued, or incurred, and permits the taking of deductions as of a different period whenever this is necessary clearly to reflect income.

Although it, or its counterpart, has been in the statute-books since 1924, it has never been judicially construed by this Court. It has, in fact, been construed only twice by the Federal courts: once in the *Cannon* case, *supra*, and again in the instant opinion.

As interpreted in the case at bar, Section 43 becomes relatively insignificant. However, if permitted to operate according to its literal terms, as was adjudged in the *Cannon* case, the statute assumes widespread importance.

While the potential importance of Section 43 might be demonstrated by myriad illustrations, the situation confronting the entire milling industry in this country should suffice for proof. Because the record before the Board of Tax Appeals was not built with certiorari in view, we are precluded from citing actual figures herein. Nevertheless, this Court may judicially recognize that, almost without exception, every flour mill (or other processor of wheat products): (a) was subject to the A. A. A. during 1935; (b) sold its flour "tax on" during that year, thereby tremendously increasing its apparent gross income; (c) after adjudication of the A. A. A.'s unconstitutionality, repaid to its 1935 customers a substantial portion of this abnormal increment to sales income; and (d) is now faced with a large income tax deficiency assessment for 1935 unless, under Section 43, it charge such reimbursements against 1935 gross receipts. The problem, therefore, is as broad as United States wheat processors are many. The amount of money involved is indicated by the fact that a $17,791.28 (R. 34) deficiency has been assessed against this single, small Kansas milling company alone.

Equally obvious, it is submitted, is the conflict between the decisions of the only two Federal courts which have passed on the issue: the Eighth Circuit Court opinion in the *Cannon* case, and the Tenth Circuit Court opinion in the case at bar.

In the *Cannon* case, the Eighth Circuit Court was presented with the argument that Section 43 did not apply for two reasons: (1) because the essence of tax laws is ascertainment and payment of taxes upon a fixed, annual basis,

and (2) because committee reports show Congress intended that section to apply only to instances of a specified character, such as rent payable in one year for a lease extending over several years (129 F. (2d) at 644-645). These are the identical two arguments advanced by the Commissioner in the case at bar.

The Tenth Circuit Court sustained contention one, saying:

> "The production of revenue ascertainable and payable at fixed intervals is the essence of any feasible system of taxation * * *" (R. 66).

The Eighth Circuit Court, on the other hand, refused to be swayed by that argument (129 F. (2d) at 645):

> "* * * it is clear that this clause [the "unless" clause of Section 43] does interfere with the conception of an inescapable, 'straight jacket' annual basis wherein all deductions must appear as paid or finally accrued. *Obviously, the clause is intended to do just that for that is what it says.*" (Italics supplied)

As for the second contention, the Tenth Circuit Court in the instant case quoted the report of the House Ways and Means Committee regarding Section 200 (d) of the 1924 Act (R. 67, last par.), the report of the Senate Finance Committee (R. 68, line 1), and concluded (R. 68):

> "These reports make it clear that the legislative intent and purpose of the 'unless provision' was to authorize the exception to the general rule in cases in which the taxpayer pays in one year interest, or rental, or other items for a period of years, and to other instances of that character * * * These transactions [in the case at bar] were not of that kind * * * For these reasons the taxpayer does not bring itself within the 'unless' clause in the statute."

On the other hand, the Eighth Circuit Court, to whom the identical committee reports were cited, reached the opposite conclusion:

> "As to the argument that the legislative history, as shown by the Committee Reports (to the Act of 1924), requires confinement to payment of accumulated expenses covering items extending over a period of years, we find no sufficient basis. The Committee Report * * * is as follows * * * [quoting said report] The Report states the occasion of the provision in section 43 but the language of the section is more general than the reason stated in the Report. Had Congress intended to limit this section to instances where 'a taxpayer pays in one year interest or rental payments or other items for a period of years,' it would have been easy to say so (compare section 107, Revenue Act 1939). There is no suggestion of such a limitation in the section. We have no difficulty in saying that the section includes the situations stated in the Report. However, we cannot write into the section such a limitation on the ground that the expression in the Committee Report suggests such action (Helvering vs. City Bank Farmers Trust Co., Trustee, 296 U. S. 85, 89 * * *" (129 F. (2d) at 645).

Nor, we submit, is there any substantial factual distinction between the two cases. As was noted by the Board in the case at bar (R. 45, lines 23-25):

> "There is no substantial difference between the facts in the instant proceeding and those in the cited [Cannon] case."

The only distinction suggested by the majority opinion in the present case is that in the Cannon case, the tax returns for 1935, 1936, 1937, and 1938 were in evidence, whereas here only the 1935 and 1937 returns were introduced (R. 69, first par.).

This "distinction" lacks substance for at least four reasons:

(1) The Cannon decision is not predicated upon any of the factual matters disclosed by post-1935 tax returns. The entire rationale of the Eighth Circuit Court's opinion is contained in the first full paragraph entitled "Application" (129 F. (2d) at 646) wherein the facts relied upon are those common to all flour processors. No special fact, peculiar to the Cannon Valley Milling Company, is so much as mentioned.

(2) Perhaps more important, the Commissioner's argument and the Tenth Circuit Court's ruling flatly deny Section 43's application in favor of *any* mill in petitioner's general situation. The only purpose served by introduction of tax returns for the years 1935 through 1938 could be to demonstrate the *quantum* of difference between deducting vendee reimbursements from income of the year of sale (1935), and deducting them from income of the years of payment; that is, to show distortion of true income reflection save by relating payments back to 1935. Yet even were petitioner able to establish a $50,000,000,000.00 distortion of its true 1935 income if reimbursements are charged against income of the years of payment, nevertheless the *nature* of those reimbursements would not thereby become changed to "expenditures in one year which are attributable to or related to business operations *extending over a number of years*, * * * [such as], * * * interest, or rental, or other items of that kind *covering a period of years*" (R. 68). Therefore the Tenth Circuit Court's opinion would deny petitioner the right to avail itself of Section 43. By the same token no wheat processor could adduce any evidence which would entitle it to the benefits of Section 43 as interpreted by the Tenth Circuit Court. Undeniably the reimbursements paid by the Cannon Valley Milling Company to its vendees were of precisely the same

character as those paid by present petitioner, nor were the Cannon Mill's payments classifiable as "interest, or rental, or other items of that kind covering a period of years". Therefore the conflict between the two decisions cannot be resolved upon a factual basis.

(3) Again, in discussing the Cannon Mill tax returns (after having already determined the point at issue, and under the cumulative introduction, "The distortion of income and resulting injustice is *further* emphasized by *other* evidence"—129 F. (2d) at 646; italics added), the Eighth Circuit Court did not consider or discuss the 1938 return. The chart relied upon by the court (129 F. (2d) at 647) contains only figures for 1935, 1936, and 1937. The reason for including the year 1936 was that the Cannon Mill made its returns upon a fiscal year basis—not according to the calendar year as in the case at bar—and its 1936 fiscal year commenced July 1, 1935 (129 F. (2d) at 647). As a matter of fact, the aforesaid chart indicates that 1936 returns were actually not in evidence even in that case (note the absence from said chart of any figure for 1936 under the heading "Reported on return"—129 F. (2d) at 647).

In addition, although, of course, the figures vary somewhat, the evidence discloses distortion by application of the Commissioner's method of tax computation in the case at bar as clearly as in the *Cannon* case. According to the aforementioned chart, the Cannon Mill's total "income" for 1935 was $50,464.03, yet if subsequent reimbursements are charged against that income, its actual net profit was $21,040.58—a difference of $29,432.45. In the case at bar, petitioner's 1935 income without giving credit to subsequent reimbursements was $114,050.23 (R. 30). If such reimbursements are charged against that income, petitioner's actual 1935 profit is $68,184.33—a difference of $45,865.90 (R. 36, 38-39).

(4) Finally, the only taxable year in controversy is the calendar year 1935. If the record shows that in order clearly to reflect 1935 income it is necessary to relate 1936-1937-1938 vendee reimbursements back to that year, the requisite foundation for application of Section 43 has been laid. Certainly the record is complete in so far as figures for 1935 are concerned, showing "apparent" net income of $114,050.23 (R. 30), reimbursements therefrom totaling $45,865.90 (R. 36, 38-39), and, hence, actual net profits for 1935 of only $68,184.33. We submit that evidence relating to calendar years subsequent to 1935 is immaterial here where the sole controversy concerns a deficiency assessment for the year 1935.

It is submitted that the issues presented by the case at bar are of considerably more than local importance, and that the welfare of the entire milling industry and, for that matter, of the fiscus itself and of taxpayers in general, solicits a guiding construction by this Court of Section 43. It is further submitted that the conflict existing between the decisions of the Eighth and Tenth Circuit Courts of Appeal should be resolved by this Court so that all mills throughout the country may be afforded uniform tax treatment.

Wherefore it is respectfully submitted that this petition for issuance of writ of certiorari be granted.

THE SECURITY FLOUR MILLS,
Petitioner.

By ROBERT C. FOULSTON,
Of Wichita, Kansas,
Counsel for Petitioner.

GEORGE SIEFKIN
and
JOHN F. EBERHARDT,
Of Wichita, Kansas,
Of Counsel for Petitioner.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

A.

Opinions Below.

The opinion of the Board of Tax Appeals, written by Member Mellott (Members Sternhagen, Van Fossan, Murdock, and Tyson dissenting without opinion, and Member Arnold writing a dissenting opinion), was rendered November 12, 1941 (R. 33). It is reported in 45 B. T. A. 671 (1941), and appears on pages 33 through 50 of the Record. Formal decision was entered on the opinion December 29, 1941, and appears at page 51 of the Record.

The opinion of the Tenth Circuit Court of Appeals was rendered March 6, 1943 (R. 64). It was written by Mr. Justice Bratton, concurred in by Mr. Justice Huxman. Mr.

Justice Phillips filed a dissenting opinion. The opinion is reported in 135 F. (2d) 165 (1943), and appears at pages 64 through 74 of the record. Judgment was entered thereon March 6, 1943, shown at page 75 of the record.

B.

Jurisdiction.

(1) Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended (Feb. 13, 1925, c. 229, § 1, 43 Stat. 938; Jan. 31, 1928, c. 14, § 1, 45 Stat. 54; June 7, 1934, c. 426, 48 Stat. 926), 28 U. S. C. A. § 347.

(2) Judgment of the Circuit Court of Appeals was entered March 6, 1943 (R. 64, 75). Petition for rehearing was denied May 22, 1943 (R. 84). Petition for writ of certiorari was filed August 21, 1943.

C.

Additional Statement.

Under heading "C" of the petition, pages 3 to 5, *supra*, a summary of the instant facts is given. We wish, here, merely to emphasize that the $45,865.90 reimbursements paid by petitioner to its vendees were in fact refunds of portions of the gross income received by petitioner in 1935 (R. 35, syl. 1 of B. T. A. opinion; R. 34, 39, 40, 45).

D.

ARGUMENT.

The court erred in resorting to committee reports in interpreting unambiguous Section 43 and, upon the basis thereof, in refusing to give effect to such statute and denying petitioner the right to deduct from 1935 income that portion thereof subsequently refunded to vendees.

During 1935 petitioner sold flour "tax on". Therefore petitioner's normal income from sales was enhanced to the

extent of the "tax payments" included in the price paid by petitioner's 1935 flour customers. The amount of this abnormal increment to sales income was approximately $100,000 (R. 40).

As of December 31, 1935, the close of the taxable year in question, this was offset by accrued liability for processing taxes. Very properly, then, in its 1935 tax returns it deducted from gross income the amount of the tax liability.

Thereafter, the tax was adjudged unconstitutional and the accrued tax liability was dissolved. Thereupon business necessity required that petitioner reimburse its vendees to the extent of processing taxes collected from them during 1935, as part of the sales price of flour, and not paid over to the fiscus.

The Commissioner subsequently disallowed the deduction for processing taxes accrued in 1935, thereby reopening, in effect, the 1935 calendar year. He refused, however, to reopen that tax year for all purposes, and denied petitioner the right to substitute, in lieu of the deduction for accrued processing taxes never paid, a deduction for that portion of 1935 income never retained by petitioner but refunded to its vendees. It will be observed that both the adjudication of the taxing statute's unconstitutionality and the customer reimbursements occurred after the close of the 1935 calendar year.

It will also be observed that the $45,865.90 repaid by petitioners to its vendees in 1936, 1937, and 1938—but principally ($41,879.50) in 1937—bore absolutely no relation to the cost of earning income in the latter three years. On the other hand, these reimbursements had a direct relation to 1935 income. They represent refunds to vendees of amounts paid by them, for processing taxes, to petitioner in 1935, and necessarily constitute a pro tanto reduction of 1935 income. The amount of money obtained from vendees in 1935 because of the then effective processing tax, and

later refunded ($45,865.90), is approximately two-thirds of petitioner's total net income for 1935 ($68,184.33). Therefore, to deny petitioner the right to the claimed deduction distorts the true picture of petitioner's 1935 net income. It can hardly be denied that a method of tax accounting which lists petitioner's net income for 1935 as $114,050.23 (R. 30) fails clearly to reflect actual income by exactly $45,865.90.

It was, we submit, to relieve against just such a situation that Section 43 of the 1934 Revenue Act was enacted.

The only two decisions interpreting Section 43 are the instant one by the Tenth Circuit Court and the contrary opinion of the Eighth Circuit Court in *Helvering* v. *Cannon Valley Milling Co., supra,* 129 F. (2d) 642.

The statute itself is, we submit, unambiguous, and clearly supports the construction given it by the Eighth Circuit Court in the Cannon case and by the dissenting opinion of Mr. Justice Phillips in the case at bar. It provides that "deductions" shall be taken in the year paid, incurred, or accrued:

> "* * * unless in order to clearly reflect the income the deductions and credits should be taken as of a different period."

The sole test laid down by the statute is whether the taking of deductions in the year of payment or accrual *clearly reflects income.* There is no suggestion that only certain *types* of deductions or credits may be granted Section 43's benefits. The statutory question is not the type of deduction or credit, but, instead, is whether that deduction or credit, *whatever its type,* should be taken as of a period different from that of payment or accrual *in order clearly to reflect income.*

That being true, and the statute being unambiguous, no justification for "interpretation" by resort to legislative

history exists. Extraneous evidence may not be relied upon to interpret or restrict an unequivocal statute (*Helvering* v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 89, 80 L. Ed. 62, 66, 1935).

Furthermore, the Tenth Circuit Court's interpretation of Section 43 is not supported by the committee report upon which it is purportedly based. That report (R. 67) states the occasion for the enactment of Section 43 (actually section 200 (d) of the 1924 act)—to extend to deductions and credits the rights previously (1921 Act) granted only to "losses". It also gives illustrative cases wherein proposed Section 43 might be applied. But nowhere is there any suggestion that the Committee intended or desired Section 43, if enacted, should be *restricted* to the examples outlined. In fact, we submit the Committee's own language demonstrates conclusively that no restriction as to type of deduction was intended:

> "The Revenue Act of 1921 * * * authorizes the Commissioner to allow the deduction of losses [note that no special *types* of losses are specified] in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. *The proposed bill extends that theory to ALL deductions and credits.*" (Italics and capitalization supplied.)

It is submitted that the Tenth Circuit Court of Appeals erred in its interpretation of Section 43, upon the basis of which erroneous interpretation all flour mills in the states embraced in that circuit are denied the rights accorded them by the statute, which rights are judicially guaranteed their brother mills doing business within the geographical confines of the Eighth Circuit Court's jurisdiction.

E.

Conclusion.

Section 43, although on the statute books since 1924,

has never been interpreted by this Court. In fact, prior to 1942 it had not been construed by any court.

There now exist two circuit court decisions, and two only, construing the statute. Those two decisions are in irreconcilable conflict. The decision of the Eighth Circuit Court, rendered July 15, 1942, is no longer open to review by certiorari or otherwise.

The vast majority of flour mills in the United States, to mention only one class of taxpayer concerned, are vitally interested in obtaining from this Court definitive interpretation of Section 43, those mills being presently confronted with a tax problem which hinges upon that statute. Only if this Court reviews the judgment of the Tenth Circuit Court in the instant case can uniform treatment of the country's countless mills be assured. In addition, Section 43 forms an important cog in the Revenue laws, and unless the errors in the Tenth Circuit Court's decision be corrected by this Court, the effect will be to create regrettable confusion regarding myriad general tax problems.

Inasmuch as the issue here involved is of the utmost importance, and inasmuch as the only judicial precedent thereon are two diametrically opposed decisions of the Tenth and Eighth Circuit Courts of Appeal, it is submitted that a writ of certiorari be issued.

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No. 276.

IN THE

Supreme Court of the United States

October Term, 1943

THE SECURITY FLOUR MILLS COMPANY, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

BRIEF OF PETITIONER.

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BRIEF OF PETITIONER.

Writ of certiorari was granted by This Court on October 11, 1943 (R. 74) to review the decree of the United States Circuit Court of Appeals for the Tenth Circuit entered in the above entitled cause on March 6, 1943 (R. 61).

That decree reversed an opinion of the United States Board of Tax Appeals promulgated November 12, 1941 (R. 32), which held that under Section 43 of the Revenue Act of 1934, Petitioner was entitled to deduct from 1935 income that portion thereof which represented processing taxes added to the sales price of flour in 1935 and which Petitioner refunded to its vendees in subsequent years after invalidation of the taxing act.

OPINIONS BELOW.

Opinion of the Tenth Circuit Court of Appeals was rendered March 6, 1943 (R. 61), appears at pages 61 through 71 of the Record, and is reported in 135 F. (2d) 165.

Opinion of the Board of Tax Appeals was rendered November 12, 1941 (R. 32), appears at pages 32 through 49 of the record, and is reported in 45 B. T. A. 671.

JURISDICTION.

(1) Jurisdiction of This Court is invoked under Section 240(a) of the Judicial Code, as amended (Feb. 13, 1925, c. 229, § 1, 43 Stat. 938; Jan. 31, 1928, c. 14, § 1, 45 Stat. 54; June 7, 1934, c. 426, 48 Stat. 926), 28 U. S. C. A. § 347.

(2) Decree of the Tenth Circuit Court of Appeals was entered March 6, 1943 (R. 61). Petition for rehearing was filed April 5, 1943 (R. 73). Substituted petition for rehearing was filed by leave of court May 22, 1943 (R. 74). The petition was denied May 22, 1943 (R. 73).

Petition for writ of certiorari was filed August 21, 1943 (R. 74). Writ of certiorari was granted by This Court on October 11, 1943 (R. 74).

STATEMENT.

Petitioner, a Kansas corporation (R. 34), is engaged in manufacturing and selling wheat flour (R. 34). As such it was subject at all times material herein to the Agricultural Adjustment Act (R. 34). Its tax returns were made upon the calendar year, accrual basis (R. 34).

During the calendar year 1935, petitioner sold flour at prices which consisted of the usual items of cost plus normal profit, but which included, in addition, an amount sufficient to cover the processing tax (R. 35).

Due to pendency of an injunction suit instituted to test constitutionality of the Agricultural Adjustment Act, petitioner paid no processing taxes to the fiscus subsequent to May 1, 1935 (R. 34). Instead, the amount of processing taxes "due" was impounded in a court designated depository from May through November, and was accrued on petitioner's books during December, 1935 (R. 34).

At the close of petitioner's 1935 calendar year, accrued liability for processing taxes amounted to $105,054.70 (R. 34—total of impounded funds, December accrual, and reserve for increases). This approximate sum was deducted from 1935 income in petitioner's tax return for that year (R. 38-39).

On January 6, 1936, the Agricultural Adjustment Act was adjudged unconstitutional by This Court (R. 34-35), and all impounded monies were returned to petitioner (R. 35).

Immediately petitioner set up in its books a suspense account, "Reserve for Processing Tax, Claims, etc.", to which it credited the impounded funds returned to it (R. 35). This reserve actually exceeded in amount the monies returned (R. 35). By intervening petitions filed in the original injunction suit and by independent actions brought after the impounded monies were returned to petitioner, various vendees unsuccessfully attempted to establish claims to the specific monies impounded (R. 35). For several months following January 6, 1936, vendees suits, claims, and settlement negotiations, ne-

gotiations with the Commissioner, and proposed and eventual enactment of Titles III and VII of the Revenue Act of 1936 projected petitioner into a period of chaotic uncertainty (R. 35-37).

Eventually, petitioner refunded $2,475.03 to its vendes in 1936, $41,879.50 in 1937, and $1,511.37 in 1938 (R. 37, 35)—a total refund of $45,865.90 (R. 35, 37). These refunds were all made with respect to 1935 flour sales, in order to reimburse vendees for processing taxes included as part of the sales price of flour purchased by them in 1935, which taxes petitioner had not paid to the fiscus (R. 32, syl. 1 of B. T. A .opinion; R. 33).

The suspense account reflected these vendee reimbursements (R. 35), and was closed out on June 30, 1939, by a transfer to surplus of $30,289.99 (R. 35).

In rendering its 1935 tax return, petitioner deducted from gross income the item of $105,054.70 representing, as above noted, processing taxes impounded and those accrued for December, together with a reserve of $1,183.64 (R. 33, lines 19-22; R. 39). This was deducted as an accrued tax liability (R. 33, lines 19-22).

On June 21, 1937, the Commissioner issued a deficiency notice, disallowing petitioner's 1935 tax deduction for taxes accrued, but not paid, during the injunctive period (R. 19, 39). In addition, the Commissioner refused to allow, in lieu of the accrued tax deduction, any deduction for the $45,879.50 customer reimbursements actually paid (R. 19, 39). An income tax deficiency of $14,702.48 and an excess profits tax liability of $3,088.80 were assessed (R. 19-20, 33).

Whereupon petitioner, on August 9, 1937 (R. 5), petitioned the Board of Tax Appeals for a redetermination of said deficiency (R. 7-26). The Board upheld petitioner's contention (R. 32-49). The Commissioner ap-

pealed to the Tenth Circuit Court of Appeals which reversed the Board's decision (R. 61-72). The issues are now before This Court upon certiorari.

It should be noted that in an amended answer filed with the Board, the Commissioner asserted an increased deficiency based upon a tax refund alleged to have been granted petitioner in connection with a closing agreement under § 506 of the 1936 Revenue Act (R. 27-30). The issue with respect to this additional deficiency was separately passed on by the Board (R. 44-46).

On this one issue, the Board upheld the Commissioner (R. 44-46). In instituting appeal to the Tenth Circuit Court of Appeals, docketed as appeal number 2556 (R. 53), the Commissioner designedly omitted this issue (R. 53-54). Petitioner then filed a separate appeal, docketed number 2589 (R. 56), from the Board's decision on this single issue (R. 56-60). In its decision of March 6, 1943, the Circuit Court of Appeals reversed the Board on this issue (R. 66-67), separate judgment being rendered thereon (R. 72). In fact, entirely separate judgments were rendered in appeals number 2556 and 2589 (R. 72).

Petition for rehearing filed with the Circuit Court by petitioner was confined to appeal number 2556. (The petition does not appear in the record, but is shown at pages 77 through 83 of the record filed with petition for writ of certiorari.) Likewise, petitioner's petition for writ of certiorari to This Court confined itself to the issues involved in appeal number 2556.

No petition for rehearing was filed in appeal number 2589, no petition for writ of certiorari has been perfected, within three months from the date of that judg-

ment or otherwise, and said judgment is now final. Therefore, no consideration will be given herein to the issues determined in appeal number 2589.

SPECIFICATION OF ERRORS.

The Tenth Circuit Court of Appeals erred:

1. In holding Section 43 of the 1936 Revenue Act inapplicable to the case at bar and in refusing to permit petitioner to deduct from 1935 gross income that portion thereof subsequently refunded to its vendees.

2. In holding that the increment to 1935 flour sales prices, representing charges made for processing taxes then due, constituted income to petitioner in 1935 although such monies were subject to controversies throughout the 1935 taxable year, were carried by petitioner in a special reserve account, and were never recognized or treated as income by petitioner until the controversies were resolved in a subsequent taxable year.

3. In refusing to permit departure from normal, *annual* accounting methods where the abnormal increment to petitioner's 1935 income and the subsequent vendee reimbursements were both part of one enormous, extraordinary, sui generis, nonrecurring transaction.

4. In upholding the disallowance by Commissioner, in a subsequent taxable year, of petitioner's deduction for accrued tax liability taken and allowed in 1935, merely because the taxing statute was declared unconstitutional in 1936 and the tax was never paid by petitioner.

PRIMARY STATUTE INVOLVED.

The governing statute in this case is Section 43 of the Revenue Act of 1934, 48 Stat. 694. That portion thereof material herein reads:

"The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period . . . "

SUMMARY OF ARGUMENT.

During 1935 petitioner sold flour tax on, the price including an amount sufficient to cover the then effective processing tax. This increment to normal income was offset by an accrued liability for processing taxes, which liability was deducted from 1935 income by petitioner in its income tax return for that year.

After adjudication of the taxing Act's unconstitutionality in 1936, petitioner, in 1936, 1937, and 1938, refunded to vendees $45,865.90. These refunds constituted reimbursements of processing taxes collected by petitioner from vendees in 1935 as part of its flour sales price.

In 1937 the Commissioner disallowed the deduction from 1935 income for accrued processing taxes; at the same time he refused to allow a deduction from 1935 income of the amount thereof refunded to vendees as aforesaid.

As computed by the Commissioner, petitioner's income for 1935 was $114,050.23. Deducting therefrom the vendee reimbursements per petitioner's contention shows an actual income for 1935 of $68,184.33.

I.

The Board found, and neither the Commissioner nor the Tenth Circuit Court opinion denies, that only by accounting for reimbursements in 1935 can petitioner's income for that year be truly reflected. Section 43 of the 1936 Revenue Act permits deductions to be taken in a year other than that of payment or accrual whenever this is necessary "in order to clearly reflect the income". Therefore these deductions should be taken against 1935 income. *Helvering v. Cannon Valley Milling Co.*, 129 F. (2d) 642 (C. C. A. 8, 1942), affirming 44 B. T. A. 763 (1941).

(a) Principal reliance of the Tenth Circuit Court's opinion is upon the rule that determination of tax liability upon an annual basis is the essence of the federal income tax system. However, it is equally fundamental that deductions must be taken in such manner as clearly to reflect income (Regs. 86, Article 41-1). And so far as possible deductions should be charged against the income in the production of which they are incurred. In any event, Section 43 is expressly designed to permit departure from the annual accounting principle wherever necessary to avoid distortion of income.

(b) The only decisions construing Section 43 are the Cannon case, *supra,* and the instant opinion of the Tenth Circuit Court of Appeals.

(c) The opinion below construes Section 43 as applicable only where a taxpayer makes expenditures in one year attributable or related to business operations extending over a number of years—such as rent and interest. It does so by relying upon committee reports in the House and Senate which preceded passage of Section 43. But the statute is unambiguous and therefore not

subject to interpretation by resort to extraneous evidence. Further, the reports do not support the construction adopted.

(d) Detailed analysis of the facts herein plainly support the Board's finding that petitioner's proposed accounting method truly reflects, and the Commissioner's distorts, petitioner's 1935 income.

(e) At the close of 1935, petitioner's right to deduct its liability for accrued processing taxes from 1935 gross income was unassailable. The Commissioner thereafter, in 1937, reopened the calendar year 1935 and disallowed the deduction upon the basis of a fact (adjudication of the A. A. A.'s unconstitutionality) transpiring in 1936. Justice requires his reopening the year for all purposes and permitting petitioner to substitute the vendee reimbursements for the tax deduction.

(f) There is no factual difference between the Cannon case and the case at bar.

The only distinction suggested by the Court is that there tax returns for 1935, 1936, 1937, and 1938 were in evidence, whereas here only those for 1935 and 1937 were introduced. But the Cannon case is not based upon these returns. Further, the Tenth Circuit Court's opinion, confining Section 43 to deductions for rent, interest, "etc.", would deny to the taxpayer in the Cannon case the right to resort to the statute. Again, the evidence in the two cases is almost identical. Finally, the only year in controversy here is 1935—and the evidence as to that year is complete.

II.

The monies returned to petitioner after the A. A. A. was permanently enjoined were "hot monies", subject to the substantial contingency of recapture by the fis-

cus and/or reimbursement to vendees. Hence, petitioner refused to exercise dominion over them, set them up in a special suspense account, and did not recognize them as income until 1937 when these controversies were ultimately determined. Hence, they did not become "income" until 1937. *Commissioner v. Brown*, 54 F. (2d) 563 (C. C. A. 1, 1931).

III.

The facts herein are unique. The items involved are, comparatively, enormous. And all relevant facts are part and parcel of one continuing transaction. Nor is there any likelihood of recurrence. Hence, ordinary tax laws are inapplicable, and the "transaction" principle should be followed. *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, 70 L. ed. 886 (1926); *Comm'r. v. Darnell*, 60 F. (2f) 82 (C.C.A. 6, 1932); *George G. Moore*, 19 B. T. A. 364 (1930).

IV.

The deduction for 1935 accrued processing tax liability, properly taken in the 1935 return, cannot be disallowed notwithstanding petitioner never paid the tax as a result of the statute's invalidation in 1936. *Davies' Estate v. Comm'r.*, 126 F. (2d) 294 (C.C.A. 6, 1942); *J. H. Dougherty's Sons, Inv. v. Comm'r.*, 121 F. (2d) 700 (C. C. A. 3, 1941).

ARGUMENT AND AUTHORITIES.

I.

IN ORDER "TO CLEARLY REFLECT INCOME", SECTION 43 PERMITS PETITIONER TO DEDUCT FROM 1935 GROSS INCOME THE CUSTOMER REIMBURSEMENTS MADE IN SUBSEQUENT YEARS.

A. Of the Applicable Law.

The primary issue here involved must be determined with little aid from precedent. Although it, or its counterpart, has been in the statute books since 1924, Section 43 of the Revenue Act of 1936 has never been judicially construed by This Court. It has, in fact, been construed only twice by the Federal courts: once in *Helvering v. Cannon Valley Milling Co.*, 129 F. (2d) 642 (C.C.A. 8, 1942), affirming 44 B. T. A. 763 (1941), and again in the Tenth Circuit Court of Appeals' decision in the instant case. With the exception of those two opinions, the authorities hereinafter cited, as well as those the Commissioner will cite, are relevant only by analogy. As was said by the Board in the Cannon case, supra, the authorities there adduced:

> " . . . furnish but slight aid in determining the issue now before us. Despite the presence of the remedial provision [Sec. 43] in all of the revenue acts from 1924 to the present few instances have arisen in which the courts or this Board have had occasion to consider it. Perhaps this is so because, in the great majority of cases, income is clearly reflected by taking the deductions and credits in accordance with the method of accounting employed. Yet the provision is not meaningless and should not be ignored." (44 B. T. A. at 770).

The refusal of the Commissioner and of the Tenth Circuit Court of Appeals to permit petitioner's deduction is premised largely upon the proposition that determination of tax liability *upon an annual basis* is the essence of the federal income tax system. This we concede. There are, however, other vital considerations which should not be ignored.

Another fundamental precept of all taxation statutes since 1916, and one which of necessity frequently conflicts with the annual accounting requirement, is that income must be truly reflected. Even the Commissioner's own regulations attest to this. For example, see Regulations 86, Article 41-1:

> "The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of *the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income.*" (Italics ours).

In seeking to meet the requirement of true income reflection Congress and courts have alike countenanced departures from the rigid annual accounting concept. "Federal income tax legislation", says the court in the Cannon case, *supra,* 129 F. (2d) at 646, footnote 3, "is a progressive growth based upon developing experience." Continuing, the court observes:

> "Several distinct lines of growth are evident. One of these concerns us here. While an annual period has always been maintained as the normal basis for taxation, experience soon developed that injustice would result in some instances from a strict adherence thereto. This experience led the Congress to provide departures from this annual basis in specified situations for the purpose of avoiding injustice."

Thus the original Act of 1909 required computation of taxes strictly upon the "cash basis" (although the Treasury made exceptions with reference to accounts receivable and payable). This method, adhering strictly to the annual accounting period, was unworkable. The first departure therefrom was the 1913 Act which introduced the phrase "arising or accruing". This was enlarged by the 1916 Act (Sec. 8 (g); cf. Section 13(a), (b), (d)) which permitted preparation of tax returns upon *any* basis which truly reflected income. Section 212(b) of the 1918 Act (which became Section 41 of the Acts of 1928, 1932, and 1934) elaborated upon the principle permitting and requiring computation of taxable income to be according to that method of accounting which truly reflected income. The 1928 Act introduced present Section 42 relating to allocation of items of gross income. Finally, Section 200(d) of the 1924 Act (which became Section 43 of the 1928 and subsequent Acts) expressly provided deductions *might be taken as of a different period than the taxable year in which paid, incurred, or accrued, "in order to clearly reflect the income"*. (Compare a somewhat similar provision of the 1921 Act—Sec. (a) (4)—relating and confined to "losses".)

These, together with other enactments, constitute a definite qualification of the Procrustean annual accounting concept. For detailed discussion of this evolution, see 2 Mertens, *The Law of Federal Income Taxation* (1942), § 12.05, pages 128 *et seq.*, and *Helvering v. Enright Estate*, 312 U. S. 636, 85 L. ed. 1093 (1941). In 2 Mertens, *supra*, § 12.06, p. 138, that noted tax authority says:

> "While the taxable year is inelastic, there is considerable scope for elasticity in fitting the items of

deduction or income into the taxable period . . . The 'tide of income' continues, despite all efforts to hold it within specific periods, to ebb and flow over the dividing lines between the statutory taxable years.

"The purpose of many of the statutory provisions, regulations, and decisions on methods of accounting is to overcome, so far as may be, the artificiality of the taxable year as a unit of time."

These enactments further constitute a definite attempt to build a tax system which accords with sound business accounting methods. Taxation is today an intensely practical matter (*Farmers Loan & Trust Co. v. Minnesota*, 280 U. S. 204, 212, 74 L. ed. 371, 1930), and the trend is towards acceptance of business accounting practices. As Dr. Roswell Magill said, in an address before the American Bar Association on August 28, 1934:

"One final trend to which I shall briefly refer before going on to consider what the future may hold is the increasing acceptance of accounting principles in the statute and in the decisions. Some lawyers will dispute the accuracy of this statement, but as courts and legislators have come to understand better that accountants have a reasonably adequate and tested technique for arriving at an accurate statement of business profits, there has been a tendency to bring the law and practice into harmony with this pattern. In my judgment, this trend is wholly desirable. The more nearly the income subjected to tax corresponds with the income determined for ordinary business purposes, the less the encouragement to artificial transactions for tax purposes only."

This brings us to another doctrine relevant to the issue under consideration. One of the touchstones of business

accounting is that *expenditures should be related to and charged against the income in the production of which they have been incurred.* Victor H. Stempf, "A Critique of the Tentative Statement of Accounting Principles", *The Accounting Review* (March, 1938), says:

> "One of the fundamental tenets of accounting requires that expenses should be charged against the income in the production of which they have been incurred.
>
> "The income statement for a year should reflect all determinable items *applicable to the year,* whether recurring, nonrecurring or extraordinary, and minor items *applicable to prior years* which will not distort the results of the current year. On the other hand, charges and credits applicable to prior years which would tend to distort current years' net results should be carried to earned surplus.
>
> *"It is unsound to credit extraordinary incomes to current profit and loss and to charge extraordinary losses to current surplus.* Both should be handled consistently and both should be disclosed." (Italics added).

And see Magill, *Taxable Income* (1936), p. 167:

> "The general theory of accrual accounting, as distinguished from accounting on a cash receipts basis, is to enter income as of the period during which it has been earned, though perhaps not collected, and to charge against such income 'the expenses incurred in and properly attributable to the process of earning income during that period', whether or not actually paid."

Although Mr. Mertens considers this principle of correlating income and deductions an "exception" to be

sparingly applied (2 Mertens, *supra*, § 12.23), it has found increasing recognition by the courts. (1) And see Paul & Mertens, *Law of Federal Income Taxation* (1930), § 11.104, p. 594.

From the foregoing it must be apparent the annual accounting principle is not inexorably applied. Neither, we submit, is the law concerning when a given item is deductible as clearly settled as the opinion below assumes. Thus see § 12.01, pages 119-120, of 2 Mertens, *supra*:

> "The fundamental questions of when items become income and when items are deductible, despite years of extensive litigation, remain today not only as troublesome as ever, but even more so. . . The struggle to adhere to the fundamental requirement that both income and deductions be fitted into a lim-

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(1) *Helvering v. Union Pacific Rly. Co.*, 293 U. S. 282, 79 L. ed. 363 (1934); *American National Co. v. U. S.*, 274 U. S. 99, 71 L. ed. 946 (1927); *U. S. v. Anderson*, 269 U. S. 422, 70 L. ed. 347 (1926); *Brooklyn Union Gas Co. v. Comm'r.*, 62 F. (2d) 505 (C. C. A. 2d, 1933); *Comm'r. v. Old Dominion Steam Ship Co.*, 47 F. (2d) 148 (C. C. A. 2d, 1931); *Hyams Coal Co. v. U. S.*, 26 F. (2d) 805 (E. D. La., 1928); *Bonwit, Teller & Co. v. Comm'r.*, 53 F. (2d) 381 (C. C. A. 2d, 1931); *Alland & Bros. v. U. S.*, 28 F. (2d) 792 (D., Mass., 1928); *Miller & Vidor Lumber Co. v. Comm'r.*, 39 F. (2d) 890 (C. C. A. 5th, 1930); *Bonded Mortgage Co. v. Comm'r.*, 70 F. (2d) 341 (C. C. A. 4, 1934); *Lichtenberger-Ferguson Co. v. Welch*, 54 F. (2d) 570 (C. C. A. 9, 1931); and *Godfrey L. Cabot, Inc. v. Comm'r.*, 40 B. T. A. 64 (1939). See, also, *Fawcus Machine Co. v. U. S.*, 282 U. S. 375, 75 L. ed. 397 (1931); *Helvering v. Russian Finance & Const. Corp.*, 77 F. (2d) 324 (C. C. A. 2d, 1935); *Comm'r. v. St. L. S. W. Rly. Co.*, 66 F. (2d) 633 (C. C. A. 8, 1933); *Comm'r. v. So. Rly. Co.*, 74 F. (2d) 887 (C. C. A. 4, 1935); *Ill. Terminal Co. v. Comm'r.*, 5 B. T. A. 15 (1926); *Cinn., Findlay & Fort Wayne Rly. v. Comm'r.*, 5 B. T. A. 108 (1926); *Va., Carolina Securities Corp. v. Comm'r.*, 6 B. T. A. 84 (1927); *New Orleans, Tex. & Mexico Rly. v. Comm'r.*, 6 B. T. A. 436 (1927); *Great Northern Rly. Co. v. Comm'r.*, 8 B. T. A. 225 (1927); *Kahuku Plantation Co. v. Comm'r.*, 12 B. T. A. 977 (1928); and *Linderman, Exor., v. Comm'r.*, 28 B. T. A. 113 (1933).

> ited and inelastic period of time within the taxable year or taxable period, often resulting in a conflict with a reasonably fair result to either the government or the taxpayer, is the source of most of the irritations and complexities of the problem."

More to the point, how can citation of the "annual accounting principle" possibly support the Circuit Court's refusal to apply Section 43 of the 1936 Revenue Act when that statute is expressly designed to countenance departures from such principle? Section 43 provides that deductions and credit shall be taken:

> " . . . for the taxable year in which 'paid or accrued' or 'paid or incurred' . . . *unless* in order to clearly reflect the income the deductions or credits should be taken *as of a different period.*" (Emphasis supplied).

Section 43 expressly and unequivocally permits deductions to be taken in some year other than the year of payment or accrual if (a factual problem we shall presently treat) such be necessary truly to reflect income. *In fact, the very purpose of Section 43 is to abolish the requirement that deductions be taken only in the year of payment or accrual.* Thus (if authority for this obvious assertion be necessary), see 1 Paul & Mertens, *supra*, § 11.104, p. 596:

> "This provision [Sec. 43], allowing deductions or credits to be taken in a period different from that in which they are paid or accrued, or paid or incurred, was designed to ameliorate some of the hardships connected with the taxable year as a unit of time and we may expect that in the future it will be more often resorted to in a remedial way."

Again, see 2 Mertens, supra, § 12.22, p. 162:

> "The [present] Code and prior acts provide that deductions and credits (other than the corporation dividends paid credit provided in section 27) are to be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order clearly to reflect the income the deductions or credits should be taken as of a different period. In other words, the usual method of accounting employed by the taxpayer may be departed from with respect to deductions and credits, if income will be more clearly reflected by shifting the item to another year or accounting period. *This provision was designed to ameliorate some of the hardships connected with the taxable year as a unit of time.*" (Italics added.)

The Eighth Circuit Court of Appeals in the Cannon Case, *supra*, made short shrift of this contention, saying (129 F. (2d) at 645):

> ". . . it is clear that this clause [the 'unless' clause of Section 43] does interfere with the conception of an inescapable, 'straight jacket' annual basis wherein all deductions must appear as paid or finally accrued. *Obviously, the clause was intended to do just that for that is what it says.*" (Italics ours.)

The Tenth Circuit Court of Appeals cites no authority to support its disregarding the plain letter of Section 43, nor, we submit, does any such precedent exist. The decisions cited to that court by the Commissioner, and which, presumably, will be relied upon by the Commissioner here, furnish no justification for the decision below. Many, even most, of those decisions were decided prior to enactment of Section 43 or involved controver-

sies relating to pre-1924 taxable years. (2) Hence, they cannot possibly be determinative here.

Several discuss not *when* but *whether* a controversial item is income or a proper deduction. (3) That is not

(2) *Burnet v. Stanford & Brooks Co.*, 282 U. S. 359, 75 L. ed. 383 (1931) (involved tax years 1913 through 1920); *Heiner v. Mellon*, 304 U. S. 271, 82 L. ed. 1337 (1938) (involved tax year 1920); *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 76 L. ed. 1197 (1932) (involved tax years 1917 through 1922); *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 538 (1930) (involved tax year 1919); *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115, 74 L. ed. 733 (1930) (involved tax year 1920); *Lewellyn v. Electric Education Co.*, 275 U. S. 243, 72 L. ed. 262 (1927) (involved tax year 1918); *U. S. Cartridge Co. v. U. S.*, 284 U. S. 511, 76 L. ed. 431 (1932) (involved tax years 1918 through 1922); *Burnet v. Huff*, 288 U. S. 156, 77 L. ed. 670 (1933) (involved tax year 1920); *Highland Milk Condensing Co. v. Phillips*, 34 F. (2d) 777 (C. C. A. 3, 1929) (involved tax years 1917-1918); *Price Iron & Steel Co. v. Burnet*, 45 F. (2d) 921 (App. D. C., 1930) (involved attempt to relate back to 1920 loss sustained in 1925); *Chicago, R. I. & P. Rly. Co. v. Comm'r.*, 47 F. (2d) 990 (C. C. A. 7, 1931) (involved tax years 1916 through 1919); *Uvalde Co.*, 1 B. T. A. 932 (1925) (involved tax year 1921); *Morrison-Ricker Manufacturing Co.*, 2 B. T. A. 1008 (1925) (involved tax years 1917 through 1920); *Celluloid Co.*, 9 B. T. A. 989 (1927) (involved tax years 1918 through 1920); and *Trippensee Manufacturing Co.*, 15 B. T. A. 15 (1929) (involved tax year 1921).

(3) *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 75 L. ed. 383 (1931) (whether compensatory award for breach of contract was income or return of invested capital); *Heiner v. Mellon*, 304 U. S. 271, 82 L. ed. 1337 (1938) (whether profits from sales made during a long-continuing liquidation of a partnership business are income); *Brown v. Helvering*, 291 U. S. 193, 78 L. ed. 725 (1934) (whether reserve for anticipated cancelations of commission was deductible); *U. S. Cartridge Co. v. U. S.*, 284 U. S. 511, 76 L. ed. 431 (1932) (whether increase of market value over inventory value of goods was income); *U. S. v. Safety Car Heating & L. Co.*, 297 U. S. 88, 80 L. ed. 500 (1935) (whether patent infringement recovery was capital, and whether difference between estimated value of the "chose in action" and amount of recovery is a deductible loss); *Ben Bimberg & Co. v. Helvering*, 126 F. (2d) 412 (C.C.A. 2d, 1942) (whether taxpayer could deduct from taxable refund received the amount of credits given to customers but later—next year—canceled); *Penn v. Robertson*, 115 F. (2d) (2d) 167 (C.C.A. 4, 1940) (whether "credits" received are income if taxpayer never receives benefit therefrom); *Uvalde Co.*, 1 B.T.A. 932 (1925), (whether "reserves" deductible); and *Morrison-Ricker Manufacturing Co.*, 2 B.T.A. 1008 (1925) (whether "reserves" deductible).

our problem. Others deal with the related but distinguishable question of when an item of *gross income* is to be accounted for as such. (4) Few of the opinions contain any indication of whether the item in controversy would, however treated, be of significance in determining "true income" of the taxpayer, and at least one case (*Brown v. Helvering*, 291 U. S. 193, 78 L. ed. 725, 1934) dealt with routine, recurring items.

Further, we concede, of course, that *ordinarily* deductions must be taken as of the taxable period during which they are paid, incurred, or accrued. We merely contend —and this is all the Cannon decision holds—that *under exceptional circumstances, where to follow the usual practice would distort the taxpayer's income,* Section 43 permits deductions to be taken as of a different period. Yet nearly every one of the Commissioner's authorities is an "ordinary" case—a case in which there was no evidence introduced or contention advanced that the Commissioner's computation method failed truly to reflect income, in which Section 43 (or, for that matter, Sections 41 or 42) was not relied upon, discussed, or

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(4). *Heiner v. Mellon*, 304 U. S. 271, 82 L. ed. 1337 (1938); *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 76 L. ed. 1197 (1932); *U. S. Cartridge Co. v. U. S.*, 284 U. S. 511, 76 L. ed. 431 (1932); *U. S. v. Safety Car Heating & L. Co.*, 298 U. S. 88, 80 L. ed. 500 (1935); *Guaranty Trust Co. v. Comm'r.*, 303 U. S. 493, 82 L. ed. 975 (1938); *London-Butte Gold Mines Co. v. Comm'r.*, 116 F. (2d) 478 (C. C. A. 10, 1940); *Comm'r. v. Alamitos Land Co.*, 112 F. (2d) 648 (C.C.A. 9, 1940); *Jamaica Water Supply Co. v. Comm'r.*, 125 F. (2d) 512 (C.C.A. 2d, 1942); and *Sportwear Hosiery Mills v. Comm'r.*, 129 F. (2d) 376 (C.C.A. 3rd, 1942).

even referred to, and in which no issue was raised concerning true reflection of income. (5) Palpably, therefore, these decisions are not controlling in the case at bar.

Nor, we submit, is any of these decisions authoritative here merely because it was decided after enactment of Section 43. Obviously decisions rendered or involving taxable years prior to 1924 cannot be material. But neither is a decision rendered after 1924 (and involving a post-1924 taxable year) which does not purport to determine the effect of the statute. Section 43 does not affect the traditional requirement that deductions be taken for the year in which they are paid, accrued, or incurred *unless* adoption of the usual procedure fails "to clearly reflect income". Hence, after 1924 as before, courts properly adhere to the old requirement *where no showing or contention of "distortion" is made.*

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(5) *North American Oil Consolidated v. Burnet*, 286 U. S. 417, 76 L. ed. 1197 (1932); *Lewellyn v. Electric Education Co.*, 275 U. S. 243, 72 L. ed. 262 (1927); *U. S. Cartridge Co. v. U. S.*, 284 U. S. 511, 76 L. ed. 431 (1932); *Burnet v. Huff*, 288 U. S. 156, 77 L. ed. 670 (1933); *U. S. v. Safety Car Heating & L. Co.*, 297 U. S. 88, 80 L. ed. 500 (1935); *Guaranty Trust Co. v. Comm'r.*, 303 U. S. 493, 82 L. ed. 975 (1938); *Saunders v. Comm'r.*, 101 F. (2d) 407 (C.C.A. 10, 1939); *London-Butte Gold Mines Co. v. Comm'r.*, 116 F. (2d) 478 (C.C.A. 10, 1940); *Highland Milk Condensing Co. v. Phillips*, 34 F. (2d) 777 (C.C.A. 3, 1929); *Price Iron & Steel Co. v. Burnet*, 45 F. (2d) 990 (App. D. C., 1930); *Chicago, R. I. & P. Rly. Co.*, 47 F. (2d) 990 (C.C.A. 7, 1931); *Comm'r. v. Alamitos Land Co.*, 112 F. (2d) 648 (C.C.A. 9, 1940); *Jamaica Water Supply Co. v. Comm'r.*, 125 F. (2d) 512 (C.C.A. 2d, 1942); *Ben Bimberg & Co. v. Helvering*, 126 F. (2d) 412 (C.C.A. 2d, 1942); *Sportwear Hosiery Mills v. Comm'r.*, 129 F. (2d) 376 (C.C.A. 3rd, 1942); *Griffin v. Smith*, 101 F. (2d) 348 (C.C.A. 7, 1939); *Penn v. Robertson*, 115 F. (2d) 167 (C.C.A. 4, 1940); *Uvalde Co.*, 1 B.T.A. 932 (1925); *Morrison-Ricker Mfg. Co.*, 2 B.T.A. 1008 (1925); *Trippensee Mfg. Co.*, 15 B.T.A 15 (1929); *South Dakota Concrete Products Co.*, 26 B.T.A. 1429 (1932).

Therefore cases adduced by the Commissioner ([6]) for the proposition:

> "Notwithstanding the advent of this clause [Sec. 43] the courts have adhered to the principles outlined in the preceding branch of the discussion, just as they did before that time" (Comm'r.s Brief to the Tenth Circuit Court, p. 39),

prove nothing merely because of their recent vintage.

Of all the Commissioner's numerous authorities, only eight, we submit, are even arguably analogous. In none of the others is Section 43 (or, for that matter, Section 41, 42, or any comparable statute) involved, relied upon, or mentioned; and in none of them is there any showing or contention of an extraordinary situation requiring that a deduction be taken in another period than that in which it was paid, accrued, or incurred, in order clearly

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([6]) *Guaranty Trust Co. v. Comm'r.*, 303 U. S. 493, 82 L. ed. 975 (1938); *Penn v. Robertson*, 115 F. (2d) 167 (C.C.A. 4, 1940); *Griffin v. Smith*, 101 F. (2d) 348 (C.C.A. 7, 1939); *Saunders v. Comm'r.*, 101 F. (2d) 407 (C.C.A. 10, 1939); and *South Dakota Concrete Products Co.*, 26 B.T.A. 1429 (1932). Other post-Section 43 opinions relied upon by the Commissioner before the Circuit Court are: *London-Butte Gold Mines Co. v. Comm'r.*, 116 F. (2d) 478 (C.C.A. 10, 1940); *Price Iron & Steel Co. v. Burnet*, 45 F. (2d) 921 (App. D. C., 1930) (though here a 1925 loss was sought to be related back to the tax year 1920 which was prior to Section 43's enactment); *Brown v. Helvering*, 291 U. S. 193, 78 L. ed. 725 (1934) (here, however, though the tax years of 1923, 1925, and 1926 were involved, the only substantial tax in litigation was that relating to 1923, a pre-Section 43 tax year); *U. S. v. Safety Car Heating & L. Co.*, 297 U. S. 88, 80 L. ed. 500 (1935) (here, again, the attempt was to relate a 1925 item back to 1913, a pre-Section 43 tax year); *Comm'r. v. Alamitos Land Co.*, 112 F. (2d) 648 (C.C.A. 9, 1940); *Jamaica Water Supply Co. v. Comm'r.*, 125 F. (2d) 512 (C.C.A. 2, 1942); *Ben Bimberg & Co. v. Helvering*, 126 F. (2d) 412 (C.C.A. 2, 1942); *Sportwear Hosiery Mills v. Comm'r.*, 129 F. (2d) 376 (C.C.A. 3, 1942); *Stokes v. U. S.*, 19 F. Supp. 577 (S. D. N. Y., 1937); and *De Loss v. Comm'r.*, 28 F. (2d) 803 (C.C.A. 2d, 1928).

to reflect income. Those eight cases we shall discuss, very briefly.

(1) *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 75 L. ed. 383 (1931).

The taxable years involved were 1913 through 1916, and 1920; hence Section 43, enacted in 1924, was not considered and the decision cannot therefore control here. Also, although Section 212 (b) of the 1918, 1921, 1924, and 1926 Acts (present Sec. 41) was perhaps applicable, the court specifically points out that the taxpayer made no attempt to avail himself of its provisions (282 U. S. at 366, 75 L. ed. at 388).

(2) *Heiner v. Mellon*, 304 U. S. 271, 82 L. ed. 1337 (1938). The taxable year in issue was 1920. Therefore, Section 43 was not involved. Question for determination was whether and when the taxpayer received "gross income". He neither contended nor proved the Commissioner's method of computation failed properly to reflect his income, and the court emphasized:

> "Section 212 (b) of the Revenue Act of 1918 [present Section 41] provides that the net income shall be computed 'in accordance with the method of accounting regularly employed in keeping the books of' the taxpayer, *and it is not shown that the method employed clearly failed to reflect net income.*" (304 U. S. at 277, 82 L. ed. at 1343; emphasis supplied).

In passing, we wish to suggest a distinction between Sections 41 and 42, on the one hand, and Section 43, on the other.

Section 41 enacts that net income shall be computed "in accordance with the *method of accounting* regularly employed in keeping the books of taxpayer"; but if no

such *method* of accounting has been employed, or if the *method* used does not clearly reflect income, then "the computation shall be made in accordance with such *method* as in the opinion of the Commissioner does clearly reflect the income." Note this section says nothing as to the period in which items of income or deduction shall be taken. It gives no authority to account for such items in periods other than those in which paid, incurred, accrued, or received. *In fact, it does not even refer to individual items of account.* Rather, it deals with general *methods* of accounting (as, for example, cash and accrual).

Arguably, Section 42 goes little further. It does not expressly provide items of income may be accounted for in a period other than that in which received or accrued. It says, merely, that items of gross income "shall be included in the gross income for the taxable year in which *received* [not "or accrued"] by the taxpayer, unless, under *methods* of accounting *permitted under Section 41*, such amounts are to be properly accounted for as of a different period."

Section 43, on the other hand, expressly authorizes the taking of *individual items* of deduction or credit in a period other than that in which paid, accrued, or incurred, irrespective of the general accounting methods employed. The test under this statute is not whether taxpayer's *method of accounting* truly reflects income. Instead, it is whether accounting for *a particular deduction* in the year paid, accrued, or incurred truly reflects income.

Since there is a patent distinction between the treatment of isolated items (deductions) in an account, and a general "method of accounting" (*Stern Brothers*, 13 B. T. A. 1192, 1928), Section 43 is broader and more

pliable than either Section 41 or Section 42. At least it goes much further than Section 41.

We make these observations because several of the Commissioner's precedents consider when gross income is received, rather than when deductions may be taken; and because he will term Section 41 a "closely-related provision" to Section 43.

(3) *Lucas v. American Code Co.*, 280 U. S. 445, 74 L. ed. 438 (1930). Here taxpayer sought to reopen taxable year 1919 and deduct from that year's gross income a loss which was, in 1919, contingent as to both liability and amount, and which did not materialize until 1923. Since the tax year involved was 1919, Section 43 was inapplicable. No other statute existed authorizing the deduction to be taken in a year other than that (1923) in which it both accrued and was paid.

Taxpayer made no contention that his proposed accounting truly reflected and the Commissioner's distorted his income. And, as we have heretofore pointed out, Section 41 deals only with *general* methods of accounting and could hardly authorize taxpayer's treatment of this *individual deduction*.

The Court does note (280 U. S. at 449, 74 L. ed. at 540) that Section 41 requires the employment of accounting methods which truly reflect income, and comments that the Commissioner should be accorded "much latitude for discretion" in determining whether the method employed meets this test. However, this discretion is subject to review by the Board and Courts (*Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115, 74 L. ed. 733, 1930; *Hyams Coal Co. v. U. S.*, 26 F. (2d) 805, E. D. La., 1928; *Reynolds Cattle Co.*, 31 B. T. A. 206, 1934). For complete discussion of this, see 2 Mertens, *supra*, § 12.14,

p. 153, and the numerous authorities there cited. Again, although Section 41 specifically invokes the Commissioner's discretion; Section 43 does not. Finally, the Commissioner has never, in the case at bar, disallowed petitioner's contention upon the ground that petitioner's method does not properly reflect income. Instead, he has consistently maintained that *as a matter of law* the customer reimbursements cannot be accounted for in 1935, not because to do so fails truly to reflect income or because accounting for them in the years of payment does reflect income properly, but simply because no liability to make reimbursements accrued in 1935. Therefore his discretion", if it exists, is inoperative here (*Carondelet Bldg. Co. v. Fontenot*, 111 F. (2d) 267, C. C. A. 5, 1940).

(4) *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115, 74 L. ed. 733 (1930). The taxable years in controversy were 1909 through 1920. Therefore Section 43 was not considered. Nor did any comparable statute authorize the allocation, to income of prior years, of a voluntary bonus paid to taxpayer's officers in 1920. Note, incidentally, that there it was the Commissioner who sought to relate back the deduction. He cited Section 212 (b) of the 1918 Act (present Sec. 41) and asserted the taxpayer's "*method* of accounting" failed properly to reflect income. The court properly held this general statute gave no authority for taking this individual deduction in prior taxable periods.

(5) *Brown v. Helvering*, 291 U. S. 193, 78 L. ed. 725 (1934). The taxable years involved were 1923, 1925, and 1926. Section 43 (enacted in 1924) was, then, applicable to the latter two years. However, it was not cited, relied upon, or mentioned in the case—perhaps because the principal year in controversy was 1923 to which Section 43 was inapplicable. Deficiencies claimed were, for 1923,

$17,923.03; for 1925, $1,520.19; for 1926, $944.30.) In any event, not having considered the application or effect of Section 43, this decision is not determinative of the instant case.

Furthermore, on its facts the Brown case is not in point. Taxpayer was an insurance agent. For each policy sold he received, monthly, an "overriding commission". In event the policy was later canceled, or the risk was reinsured, taxpayer's previously paid (or credited) commission was refunded (or canceled) pro tanto. From 1896 until 1923 taxpayer employed a regular *method of accounting* for these commissions. He reported as income all commissions earned during each taxable year; from that income he deducted all "rebates" suffered that year.

In 1923 taxpayer determined to change his regular method of accounting. He set up on his books a "reserve" for anticipated commission cancelations, based upon past experience, and from his gross commissions for 1923 he deducted in his 1923 tax return the amount of this reserve for return commissions. He followed the same procedure in his 1925 and 1926 returns. The Commissioner disallowed the deductions and assessed deficiencies.

Principal issue in the case was whether these "reserves" were deductible. The court held they were not, stating that the Revenue Acts recognized reserves only in specified situations.

Taxpayer then argued the use of reserves constituted his "regular method of accounting" by which the Commissioner was bound, relying upon Section 41. Obviously, however, his regular method was that employed prior to 1923! Note, also, that taxpayer made no contention his earlier accounting practices failed properly to reflect income. The Commissioner, exercising the discretion vested

in him by Section 41, held taxpayer's former method truly reflected income, disallowed the change, and was sustained by the court. For the same reason the Commissioner disallowed taxpayer's alternative contention that he be permitted to prorate commissions over the life of the policies, and was upheld by the Court.

Plainly these facts distinguish the Brown decision from the instant case. Apart from the fact that the Brown case was primarily a controversy over *whether*, not when, a deduction may be taken, the taxpayer there did not contend his income was being distorted by the Commissioner's method of accounting. The return commissions were regular, routine, recurring items which, in the long run, would "balance off". Unquestionably *either* taxpayer's or the Commissioner's method would result in a fair reflection of income. Further, this was a true controversy concerning a general *method* of accounting—a system of handling numerous, recurring items—to which Section 41 fully applied. Finally, Brown did not assert any rights under Section 43, and that statute was not considered in the opinion.

(6) *De Loss v. Comm'r.*, 28 F. (2d) 803 (C. C. A. 2d; 1928). Taxable years involved were 1920 and 1921. Section 43 was therefore inapplicable, although its prototype Section 214 (a) (4) of the 1921 Act (limited to "losses") was in existence. Taxpayer owned stock in a corporation which in 1920 was dissolved, its affairs wound up, and most of its assets sold for less than outstanding debts. Plainly taxpayer's stock was worthless in 1920. Taxpayer sold part of his shares in 1920 and the balance in 1921, both for less than the broker's selling charge. He sought to deduct the loss sustained in each year. The court held the stock became worthless in 1920, could no longer fluctuate in value, and therefore the loss was of

necessity sustained in that year, the 1921 sale being purely fictitious.

There was no contention that accounting for the entire loss in 1920 did not properly reflect income. Of Section 214 (a) (4) of the 1921 Act (presumably—the court does not refer to it by section number) the court merely commented that it had no *retroactive* application to the tax year 1920 (the year the loss occurred):

> "The express exceptions introduced in 1921, allowing such a practice, are to be taken as ex gratia, *and indicate no analogous intent in the earlier statute.* We hold that the loss upon the shares sold in 1921 was sustained in 1920." (Italics ours).

(7) *Stokes v. U. S.*, 19 F. Supp. 577 (S. D. N. Y., 1937). The case involved the tax years 1927, 1928, and 1929. Section 43 was applicable. However, the taxpayer was held estopped to take his deduction in a year other than that in which it was paid, by reason of prior, inconsistent conduct in 1926, a year barred from readjustment by the statute of limitations. Further, Section 43 was held unavailable to taxpayer by reason of his failure to comply with Regulations 74.

(8) *Celluloid Company*, 9 B. T. A. 989 (1927). Most of the Board's opinion is concerned with irrelevant (here) issues of obsolescent-and-defective material deductions from inventory. The third issue involved taxpayer's right to deduct from 1920 income, largely derived from the sale of goods, returns in 1921 of defective goods sold in 1920. *This is the only case cited by the Commissioner in the instant cause wherein the taxpayer contended or proved that computing his income upon the "annual accounting period" basis would result in distortion.* In the Celluloid case, the taxpayer established

that goods returned in 1921 were in an extraordinary large amount ($128,379.21) disproportionate to normal years' returns. However, the tax year in issue—1920—antedated Section 43 (as well as Section 214 (a) (4) of the 1921 Act), so there was no statutory authority for allowing the 1921 deduction to be taken as of 1920. Without reference to statute, the Board summarily held the liability did not accrue until 1921 and could not be accounted for in 1920, citing *Morrison-Ricker Mfg. Co.*, 2 B. T. A. 1008 (1925).

It is submitted that none of the authorities relied upon by the Commissioner in the Circuit Court denies that, under Section 43, a deduction may be accounted for in a year other than that in which paid, incurred, or accrued, if such be necessary in order clearly to reflect income. The statute itself unambiguously permits this to be done. And the Cannon case, *supra* (129 F. (2d) 642) is squarely opposed to the Tenth Circuit Court's decision herein. Compare, also, *Carondelet Bldg. Co. v. Fontenot,* 111 F. (2d) 267 (C. C. A. 5, 1940), and cases cited *supra* in footnote "(1)".

As a matter of fact, the Tenth Circuit Court's discussion of the "annual accounting principle" of income taxation is not, and cannot be, the reason for refusing to apply Section 43 in the case at bar — this for the simple reason that, undeniably, the "unless" clause of that statute expressly authorizes departures from this principle. The denial of Section 43's application was based upon legislative history which, the court held, discloses the "unless" provision was intended to apply only:

> "... in cases in which the taxpayer pays in one year interest, or rental, or other items for a period of years, and to other instances of that character, in order to prevent distortion of income of the tax-

payer. It is manifest that Congress had in mind for application of the provision only instances in which a taxpayer receives income or makes expenditures in one year which are attributable to or related to business operations extending over a number of years."

Section 43, however, is unambiguous and clearly supports the construction given it by the Eighth Circuit Court in the Cannon case, *supra,* and by the dissenting opinion of Mr. Justice Phillips in the case at bar. It provides "deductions" shall be taken in the year paid, incurred, or accrued:

> " . . . unless in order to clearly reflect income the deductions and credits should be taken as of a different period."

The sole test laid down by the statute is whether the taking of deductions in the year of payment or accrual *clearly reflects income.* There is no suggestion that only certain *types* of deductions or credits may be granted Section 43's benefits. The statutory determinent is not the type of deduction or credit, but, instead, is whether the deduction or credit, *whatever its type,* should be taken as of a period different from that of payment or accrual *in order clearly to reflect income.*

That being true, irrespective of what Congress may have thought, proposed, or intended, the statute is to be interpreted and applied according to what it clearly and unmistakably says. Resort cannot be had to committee reports or any other extraneous evidence to interpret or restrict an unambiguous statute. Thus see *Helvering v. Cannon Valley Milling Co., supra,* 129 F. (2d) at 645;

> "The Report [the Committee Report upon which This Court relies in the case at bar] states the occasion of the provision in section 43 but the language of the section is more general than the reason stated in the Report. Had the Congress intended to limit this section to instances where 'a taxpayer pays in one year interest or rental payments or other items for a period of years,' it would have been easy to say so (compare section 107, Revenue Act of 1939, 26 U. S. C. A. Int. Rev. Code, § 107). We have no difficulty in saying that the section includes the situations stated in the report. However, we cannot write into the section such a limitation on the ground that the expression in the Committee Report suggests such action."

Cases in support of this principle are legion, among them: *Helvering v. City Bank Farmers Trust Co.*, 296 U. S. 85, 89, 80 L. ed. 62, 66 (1935), unofficial headnotes 2 and 3; *Wilbur v. U. S.*, ex rel., *Vindicator Consol. G. Min. Co.*, 284 U. S. 231, 237, 76 L. ed. 261, 264 (1931), unofficial headnote 2; *United States v. Missouri P. R. Co.*, 278 U. S. 269, 278, 73 L.ed. 322, 376 (1929), unofficial headnotes 2 and 3; *Federal Deposit Ins. Corporation v. Gunderson*, 106 F. (2d) 633 (C. C. A. 8, 1939); and *United States v. Board of Comm's.*, 26 F. Supp. 270 (N. D. Okla., 1939). For numerous authorities accord, see American Digest System, "Statutes", Key Numbers 190, 216, and 217.

Furthermore, the Tenth Circuit Court's interpretation of Section 43 is not supported by the committee report upon which it is purportedly based. That report (R. 64) states the occasion for the enactment of Section 43 (actually section 200 (d) of the 1924 act)—to extend to deductions and credits the rights previously (1921 Act)

granted only to "losses". It also gives illustrative cases wherein proposed Section 43 might be applied. But nowhere is there any suggestion that the Committee intended or desired Section 43, if enacted, should be *restricted* to the examples outlined. In fact, we submit the Committee's own language demonstrates conclusively that no restriction as to type of deduction was intended:

> "The Revenue Act of 1921 * * * authorizes the Commissioner to allow the deduction of losses [note that no special *types* of losses are specified] in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. *The proposed bill extends that theory to ALL deductions and credits.*" (Italics and capitalization supplied.)

We submit the Tenth Circuit Court's opinion is erroneous, first for construing unambiguous Section 43 and restricting its plain terms by resort to legislative history, and, second, for misinterpreting the legislative history relied upon by attributing to the Committee Reports a restrictive effect not therein stated.

What has just been said is equally applicable to the arguments proposed to the Tenth Circuit Court by the Commissioner (but not adopted by the Court in its opinion), (a) that Section 43 applies only to items of deduction "such as interest or rent" which help produce income, and (b) that Section 43 is restricted to payments made in one year of interest, rent, or similar items for a period of *subsequent* years.

In addition, as to the first noted contention it will hereinafter be demonstrated that the deductions claimed in the case at bar fully satisfy the test of helping produce the income from which they are sought to be deducted. And as to the second contention, why Congress

should (or could) discriminate between a taxpayer whose deduction accrues in a year prior to that in which he seeks to take it, and one who desires the benefit of his deduction in a year subsequent to its accrual, is difficult to conceive. In any event, Section 43 permits the taking of deductions in a "different", not merely a "subsequent", period than that in which they accrue.

The Commissioner also urged, in the court below, that the Cannon decision makes "prosperity or lack of prosperity" the determinant in localizing tax deductions. This, we submit, is incorrect. Whether a given method of accounting, or treatment of items in an account, does or does not truly reflect income is an objective problem. While the solution might be affected by, it certainly does not depend upon "prosperity". Nor is there so much as an inuendo in the Cannon decision that, in resolving such issue, consideration will be given to whether true reflection of income will result advantageously either to the taxpayer or to the fiscus.

It is submitted that if relation of vendee reimbursements to 1935 income is necessary in order clearly to reflect petitioner's income, Section 43 requires that the deductions be taken as of 1935. This leaves for consideration a purely factual question.

B. Of the Facts Herein.

The basic facts here involved are fully set forth in the Board's opinion (R. 32-49) and do not require detailed restating.

In general, these facts are illustrative of the tremendous, sui generis tax problem with which first domestic processors of wheat throughout the United States were confronted during existence of the Agricultural Adjustment Act and the repercussionary years following its ad-

judged invalidation. Never before (nor since) in our legal history have taxpayers been caught between the Scylla of a taxing statute which was declared unconstitutional, and the Charybdis of a "follow up" statute (Title III) which, ere the reverberations of its predecessor had died down, was introduced into Congress, enacted, and sustained by the courts. The processors were forced to solve an enormous problem sandwiched in between the two taxing statutes and caustically seasoned with the mustard of embittered public opinion and strained customer relationships.

Throughout the calendar year 1935 petitioner was subject to a tax of $1.38 per barrel of flour processed (.30c per bushel of clean dry wheat, times the administratively promulgated conversion factor of 4.6 bushels per barrel). To meet this tax, petitioner was forced to increase the sales price of flour:

> "The selling price consisted of the usual items of cost, plus normal profit, *and included in addition an amount sufficient to cover the processing tax.*" (R. 35; italics ours).

The result was that petitioner's apparent gross income for 1935 was enhanced by approximately $100,000 (estimated amount: $105,054.70—R. 39). This unnatural increment to gross earnings was due *entirely* to the processing tax, necessitating petitioner's sale of flour "tax on".

As of December 31, 1935, the close of the controversial taxable year, this was offset by an accrued liability for processing taxes (R. 34). However, on January 6, 1936, the A. A. A. was adjudicated unconstitutional and petitioner's processing tax liability was absolved (R. 34). Thereupon, "business necessity" (! !) required that pe-

titioner reimburse its vendees for taxes collected from them in the sales price of flour, and never paid by petitioner to the Treasury.

In 1936, 1937, and 1938, petitioner repaid to its vendees $45,865.90 (R. 33). Obviously these payments had absolutely no relation to the cost of earning income in the years of payment. Equally apparent is the fact that they had exactly $45,865.90 to do with acquisition of petitioner's 1935 gross receipts. They represented refunds to vendees of taxes paid by them to petitioner in 1935 as part of the sales price of flour. Therefore, they constituted pro tanto reduction of petitioner's gross income from 1935 sales. In fact, this relationship between refunds and 1935 income was admitted by the Commissioner (Stipulation of Facts, page 3, par. 8. This stipulation, incorporated in the Board's findings (R. 33), appears to have been omitted by mistake from the record herein):

> "The petitioner has made reimbursements to certain of its customers with respect to processing taxes included in sales prices of flour purchased by them during the period from May 1 to December 31, 1935, but not paid by petitioner to the Treasury Department of the United States, in the aggregate amount of $45,865.90. Of this amount the sum of $2,475.03 was disbursed during petitioner's taxable year 1936, $41,879.50 in petitioner's taxable year 1937 and $1,511.37 was disbursed during petitioner's taxable year 1938."

What effect do these items have upon petitioner's true income? Petitioner's 1936 and 1938 returns are not in evidence (R. 39—although their contents were disclosed in briefs filed with the Board), but its 1935 and 1937 returns sufficiently disclose that only by relating reim-

bursements to the year of sale can petitioner's income be truly reflected. The following chart shows petitioner's net income for 1935 and 1937 both as computed by the Commissioner (who relates reimbursements to the years of payment) and as computed by petitioner (by relating reimbursements to the year of sale):

YEAR	Deduction Taken In Years of Payment	Deduction Taken In Year of Sale	Difference
1935	$114,050.23	$68,184.33	$45,865.90
1937	$ 66,944.25 (loss)	$25,064.75 loss)	$41,879.50

That chart speaks for itself. It shows conclusively that accounting for the refunds in the years of payment distorts the true picture of petitioner's income. The Commissioner's method of computation increases petitioner's *actual* net profits from 1935 business by considerably ($22,318.43) more than one third, and it all but doubles *actual* loss from 1937 business.

For example, from normal business operations in 1937 petitioner suffered a loss of $25,064.76. *In addition,* it paid out during that year $41,879.50. But this latter item was not an expense of doing business in 1937. Nor are we able to follow the Commissioner's argument to the Circuit Court that, if anything, this "good will' reimbursement should be related forward to future years. It was paid to vendees who had purchased flour in 1935, for reasons and because of facts which transpired prior to 1937. It constituted a refund of that portion of petitioner's 1935 gross income which the vendees in question had contributed. In no event did this $41,879.50 have any bearing upon petitioner's conduct of 1937 business.

Thus, assuming $25,064.75 to be a normal milling loss for 1937, would petitioner likely discharge its salesmen and managers on the theory they had incompetently operated the mill at a $66,944.25 loss that year? Suppose

an accountant were asked, on January 1, 1938, to prepare and submit to the Securities and Exchange Commission a financial report of petitioner. Or suppose Dun and Bradstreet received, early in 1938, inquiry as to petitioner's credit. Would a report to the commission be acceptable which, without explanation, simply included the item $41,879.50 as a 1937 "expense", lumping that huge sum with petitioner's actual $25,064.75 loss? Could Dun and Bradstreet honestly report petitioner's credit as a going concern on the basis of a $66,944.25 business loss? Would a stockholder, given a financial report by petitioner's of its 1937 calendar year, become disgruntled at the management and decry the rising cost of doing business?

These are purely rhetorical questions. Upon any basis of fact or logic, the reimbursements relate entirely to business transacted and income earned in 1935. They are refunds of portions of petitioner's 1935 gross receipts and certainly, therefore, are deductions "of the kind that help produce the income". Although they did not accrue in 1935, technically speaking, nevertheless in order truly to reflect income they must be accounted for in that year.

The items in question are remarkably large—large enough to nearly double petitioner's actual 1935 profits and 1937 losses if artificially accounted for in the years of payment. The amount of money obtained from vendees in 1935 because of the then effective processing tax, and later refunded $45,865.90), is approximately two thirds of petitioner's total net income for 1935 ($68,184.33). Nor are these exceptional items the type which can be expected to readjust themselves by recurrence. (8) Rigid adherence to the taxable year as a unit of ac-

(8) See discussion of this factor by the Board in the Cannon case (44 B.T.A. at 771).

counting time ordinarily results in rough justice both to taxpayer and Government. Average business transactions of one year seldom result in sufficient abnormal gain or loss seriously to affect or distort the taxpayer's income from the entire year's business. More important yet, they, or similar items, may be expected to recur, in varying forms, in each of the ensuing years' business so that, in the long run, little would be gained by constantly readjusting computation of income for prior years. A furniture company may have to take back in one year a number of articles sold during the previous year; but the law of averages and business experience indicate that it will, by and large, suffer the same or a similar experience in most if not all of its business years. Also, minor items of this type are not of sufficient magnitude to affect true reflection of income for the year of sale. See Article 43-2 of Regulations 86 as indicating the Commissioner recognizes this factor of recurring overlapping of inconsequential items as one of the justifications for adherence to the annual accounting period. Here, however, we are dealing with a large item which petitioner cannot hope to absorb by recurrence of comparable situations in future years.

It can hardly be denied that the Commissioner's method of accounting, as sustained by the Tenth Circuit Court, fails clearly to reflect petitioner's 1935 income. A method of tax accounting which lists petitioner's net income for 1935 as $114,050.23 (R. 30) fails clearly to reflect actual income by exactly $45,865.90; it is, we submit, gross distortion of petitioner's true income picture. We submit that it was to relieve against just such a situation that Section 43 was enacted.

The hard truth of the matter is that the Commissioner has never contended and the Tenth Circuit Court of

Appeals did not hold either that petitioner's method of accounting does not or that the Commissioner's method does truly reflect petitioner's 1935 income. The decision below is predicated entirely upon the two propositions, (1) that Section 43 is inapplicable except to items paid in one year which relate to income earned over a period of several years—which, in turn, is based upon improper resort to and erroneous interpretation of Congressional Committee Reports, and (2) that the annual accounting system of income taxation must be rigidly adhered to. As has already been shown, neither of these proposition is valid. *The vital consideration herein—that petitioner's income can be clearly reflected in accordance with the mandates of Section 43 only by relating the reimbursements back to 1935—stands undenied either by the Commissioner or by the Tenth Circuit Court's decision.*

Consideration should be given, too, to what the Eighth Circuit Court in the Cannon case, *supra,* terms the "injustices" of the Commissioner's position as sustained by the Tenth Circuit Court herein.

Petitioner did not seek the increment to its 1935 gross income caused by the Agricultural Adjustment Act and the consequent necessity for increasing the sales price of flour so as to include the tax. Prior, at least, to the close of 1935 petitioner received no benefit from these added gross receipts. It acted merely as a collecting agent for the fiscus, as a conduit through which the tax monies passed from vendee to the Treasury.

As is pointed out in the Cannon opinion, no financial gain and no tax increase were incurred by reason of these tax monies for the reason that the additional income was "offset by a claimed tax deduction" (129 F. (2d) at 646). At the end of the 1935 calendar year petitioner

was incontestably entitled to a deduction for accrued processing tax liability.

It should be borne in mind that not only the vendee reimbursements, but also the adjudication of the taxing statute's invalidity—which is the sole justification for the Commissioner's retroactive disallowance of the tax deduction—occurred in subsequent calendar years. Yet when the Commissioner disallowed the tax deduction in 1937 upon the basis of facts transpiring in 1936 (adjudication of the Act's unconstitutionality), thereby reopening the 1935 calendar year, he refused to reopen that year for all purposes and denied petitioner the right to substitute, in lieu of the deduction for accrued processing taxes never paid, a deduction for that portion of 1935 income never retained by petitioner but refunded to vendees. Certainly if the tax year 1935 is to be reopened and the entire deduction for taxes disallowed, petitioner should be entitled to offset its loss of deduction to the extent it actually reimbursed its vendees in 1936, 1937, and 1938. If the A. A. A. is now to be completely ignored and petitioner's 1935 gross income item to be considered final, the Commissioner must be consistent in his treatment of the liability item. If hindsight may be employed to treat the liability (for taxes) item as tentative from its inception, it must also observe the equal tentativeness of the income item. Just as a deduction is disallowed for processing tax liability the actual *burden* of which, although the liability actually accrued and the tax was actually paid to the depository, petitioner never suffered, so deduction must be granted for that portion of gross income from flour sales the *benefit* of which, though the right thereto once accrued and though the monies were once paid to petitioner, the petitioner never realized. By ignoring the A. A. A. the Commis-

sioner has restored to income for 1935 monies not includable therein as of December 31 of that year. To be consistent he must allow a deduction to the extent of the $45,865.90 reimbursements. If the parties are to be placed back into status quo, as though no processing tax had been enacted, the restoration process must be applied to the entire picture: petitioner's gross income for 1935 is that amount of money it would have obtained had there been no A. A. A., which sum is *at least* $45,865.90 less than the figure asserted in the Commissioner's deficiency and upheld by the Tenth Circuit Court.

Inasmuch as all the relevant facts herein had become final and known prior to the Commissioner's deficiency assessment, there appears no reason for his refusing to take *all* such facts into consideration. Why should he not be compelled to take into account the customer reimbursements actually paid as well as the release of impounded monies as a consequence of the A. A. A.'s unconstitutionality? *Bohemian Breweries, Inc. v. U. S.*, 27 F. Supp. 588 (Ct. of Claims, 1939) appears to justify consideration of all factors crystalizing while "a case involving audit and determination of correct tax liability is open and under consideration". Compare *E. B. Elliott Co.*, 45 B. T. A. 82 (1941), and see Mr. Justice Cardozo's recognition of Experience's prowess as a great teacher, in *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 229 U. S. 689, 77 L. ed. 1449 (1933).

As the Eighth Circuit Court quite properly said in the Cannon case (129 F. (2d) at 646):

> "To permit the Commissioner to open up the item of deduction only to the extent it serves his purpose and to deny the taxpayer the effect of the reimbursements affecting the same item resulting in its paying a higher tax than it justly owes is an injustice to the taxpayer."

We submit that, in all fairness, and in order clearly to reflect income, it is essential that customer reimbursements paid by petitioner be allowed as a deduction from 1935 gross income.

The Cannon Valley Milling Company decision, *supra*, squarely supports petitioner's contention and is in direct conflict with the instant Tenth Circuit Court opinion. Nor is there, we submit, any factual distinction between the Cannon case and the case at bar. As was noted by the Board of Tax Appeals in the present case (R. 44):

> "There is no substantial difference between the facts in the instant proceeding and those in the cited [Cannon] case."

The only distinction suggested by the majority opinion in the present case is that in the Cannon case the tax returns for 1935, 1936, 1937, and 1938 were in evidence, whereas here only the 1935 and 1937 returns were introduced (R. 65). This "distinction" lacks substance for at least four reasons:

(1) The Cannon decision is not predicated upon any factual matter disclosed by post-1935 tax returns. The entire rationale of the Eighth Circuit Court's opinion is contained in the first full paragraph entitled "Application" (129 F. (2d) at 646), and the facts there relied upon are not peculiar to the Cannon Valley Milling

Company; instead, they are general facts common to most, if not all, processors*—including petitioner.

To prove this, we quote the first full paragraph of the court's opinion (p. 646):

> "[3] *Application.* In the months of May and June, 1935, this taxpayer collected the processing tax as a part of its sales prices. In its tax return for that year, the amount of such collections was included in its gross income and was entirely offset by a claimed tax deduction. The result was that the collections had no effect upon its net income. Three years later, the Commissioner redetermined the tax by disallowing the deduction. Since this disallowance left the gross income (which included the collections) undisturbed, the result would be that the net income would be increased by the amount of the collections. It was not until 1936 that the contingency (validity vel non of the A. A. Act) was resolved and the right of taxpayer to the accrued income from the collections was determined. Therefore, the disallowance by the Commissioner was a relation back to the tax year 1935 of an accrual which had become fixed in a later year. At the time of the redetermination it was established that only a part of the collections had remained the property of

(*) In fact, since the tax applied to all processors alike, and since each processor necessarily passed on to its vendees approximately the same proportion thereof as did all others, and since nearly every processor was compelled to give to its vendees approximately the same settlement as other processors extended to theirs, the factual situation of most processors is nearly identical. The only variance is in amounts, which is immaterial since the relation between gross income, taxes included in sales prices, and reimbursements is substantially constant—so, *proportionately*, the effect upon each processor of accounting for reimbursements in the year of sale will be the same. That is, to the extent that one processor's gross income in 1935 exceeded another's, to that same extent, and in the same relative proportion, his "taxes collected" from and reimbursements paid to vendees were likewise larger. The net result upon true reflection of income, by relating reimbursements to the year of sale, will be the same in each case.

> the taxpayer and a part of its income. All the taxpayer seeks is to have related back, from 1937, the disbursements which reduced the collections in order that its net income for 1935 will be "clearly" and truly stated. Both the deduction and the reimbursements relate to the same transaction in 1935. Clearly to disallow the deduction and to refuse the decrease thereof by the reimbursements will distort the taxable income for that year. To permit the Commissioner to open up the item of deduction only to the extent it serves his purposes and to deny the taxpayer the effect of the reimbursements affecting the same item resulting in its paying a higher tax than it justly owes is an injustice to the taxpayer."

That is, we submit, the nub of the Eighth Circuit Court's opinion, and it contains no reference to 1936, 1937, and 1938 tax returns or to any other special circumstance peculiar to the processor involved in that action.

Having held, upon the aforesaid facts alone, that "to disallow the deduction and to refuse the decrease thereof by the reimbursements will distort the taxable income for that year" (129 F. (2d) at 646), the court then, and not until then, proceeded to consider the special facts of that case including the tax returns mentioned herein by the Tenth Circuit Court. But in so doing, the Eighth Circuit Court designedly characterized these special facts as merely *further, additional* evidence of distortion:

> "The distortion of income and resulting injustice is further emphasized by other evidence. . . ." (129 F. (2d) at 646).

In this connection, compare the Board's opinion in the case at bar (R. 44).

(2) Perhaps more important, the Commissioner's argument and the Tenth Circuit Court's ruling flatly deny Section 43's application in favor of *any* mill in petitioner's general situation. The only purpose served by introduction of tax returns for the years 1935 through 1938 could be to demonstrate the *quantum* of difference between deducting vendee reimbursements from income of the year of sale (1935), and deducting them from income of the years of payment; that is, to show distortion of true income reflection save by relating payments back to 1935. Yet even were petitioner able to establish a $50,000,000,000.00 distortion of its true 1935 income if reimbursements are charged against income of the years of payment, nevertheless the *nature* of those reimbursements would not thereby become changed to "expenditures in one year which are attributable to or related to business operations *extending over a number of years* * * * [such as], * * * interest, or rental, or other items of *that kind covering a period of years*" (R. 64). Therefore the Tenth Circuit Court's opinion would deny petitioner the right to avail itself of Section 43. By the same token no wheat processor could adduce any evidence which would entitle it to the benefits of Section 43 as interpreted by the Tenth Circuit Court. Undeniably the reimbursements paid by the Cannon Valley Milling Company to its vendees were of precisely the same *character* as those paid by present petitioner, nor were the Cannon Mill's payments classifiable as "interest, or rental, or other items of that kind covering a period of years". Therefore the conflict between the two decisions cannot be resolved upon a factual basis.

(3) Again, as already noted, in discussing the Cannon Mill tax returns (after having already determined the point at issue, and under the cumulative introduc-

tion, "The distortion of income and resulting injustice is *further* emphasized by *other* evidence"—129 F. (2d) at 646; italics added), the Eighth Circuit Court did not consider or discuss the 1938 return. The chart relied upon by the court (129 F. (2d) at 647) contains only figures for 1935, 1936, and 1937. The reason for including the year 1936 was that the Cannon Mill made its returns upon a fiscal year basis—not according to the calendar year as in the case at bar—and its 1936 fiscal year commenced July 1, 1935 (129 F. (2d) at 647). As a matter of fact, the aforesaid chart indicates that 1936 returns were actually not in evidence even in that case (note the absence from said chart of any figure for 1936 under the heading "Reported on return"—129 F. (2d) at 647).

In addition, although, of course, the figures vary somewhat, the evidence discloses distortion by application of the Commissioner's method of tax computation in the case at bar as clearly as in the *Cannon* case. According to the aforementioned chart, the Cannon Mill's total "income" for 1935 was $50,464.03, yet if subsequent reimbursements are charged against that income, its actual net profit was $21,040.58—a difference of $29,432.45. In the case at bar, petitioner's 1935 income without giving credit to subsequent reimbursements was $114,050.23 (R. 30). If such reimbursements are charged against that income, petitioner's actual 1935 profit is $68,184.33—a difference of $45,865.90 (R. 35, 37).

(4) Finally, the only taxable year in controversy is the calendar year 1935. The evidence before the Board was sufficient to support (and, in our opinion, to compel) the Board's *factual* determination that the Commissioner's method of computing petitioner's 1935 in-

come did not truly reflect but, in fact, distorted its income for that year.

What more, then, was necessary? If the record shows that in order clearly to reflect 1935 income it is necessary to relate 1936-1937-1938 vendee reimbursements back to that year, the requisite foundation for application of Section 43 has been laid. Certainly the record is complete in so far as figures for 1935 are concerned, showing "apparent" net income of $114,050.23 (R. 30), reimbursements therefrom totalling $45,865.90 (R. 35, 37), and, hence, actual net income for 1935 of only $68,184.33. We submit that evidence relating to calendar years subsequent to 1935 is immaterial here where the sole controversy concerns a deficiency assessment for the year 1935.

It is submitted that Section 43 is applicable here, and that the decision of the Tenth Circuit Court is erroneous and in direct conflict with that of the Eighth Circuit Court in the Cannon case, *supra*.

C. Of the Necessity for Compliance With Regulations 86.

In his brief to the Tenth Circuit Court the Commissioner urged Section 43 was unavailable to petitioner for failure to comply with Article 43-1 of Regulations 86 by taking deductions for reimbursements in its 1936, 1937, and 1938 returns and submitting with those returns a request that the deductions be shifted to 1935. No mention of this point was made in the majority opinion of the Tenth Circuit Court's decision. However, it was discussed in the dissenting opinion (R. 71) and will be treated here to forfend against its renewal before This Court. For several reasons the objection lacks merit.

In the first place, the Commisisoner advanced no such contention before the Board of Tax Appeals. The issue

was not raised in his answer before the Board. (R. 27-30), mentioned in his brief to the Board, or adverted to in oral argument.

It is a general principle of appellate law that no contention not submitted by appellant to the trial court will be considered on appeal. ([9]) Legion are the decisions applying this rule to appeals from the Board of Tax Appeals. ([10]) Recently certain qualifications upon this rule have been introduced, permitting departure therefrom under "exceptional circumstances" (*Hormel v. Helvering,* 312 U. S. 552, 85 L. ed. 1037, 1941; *Helvering v. Richter,* 312 U. S. 561, 85 L. ed. 1043, 1941). Thus, in the two cited authorities, the Commissioner was permitted to raise a new contention on appeal to the circuit court where This Court had enunciated a new, applicable rule of law *after* the Board's original opinion was handed down. Hence, the Commissioner had had no opportunity to present the issue to the Board. However, in the case at bar the regulation relied upon has been in existence since 1925, and there is, therefore, no excuse whatever for his failure to make the point before the Board. There being no exceptional circumstances to jus-

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([9]) For example, see: *New Amsterdam Casualty Co. v. Farmers' Co-op. Union,* 2 F. (2d) 214 (C.C.A. 8, 1924); *New York Life Ins. Co. v. Doerksen,* 75 F. (2d) 96 (C.C.A. 10, 1935); *American Home Fire Assur. Co. v. Hargrove,* 109 F. (2d) 86 (C.C.A. 10, 1940); and *Liberty Petroleum Co. v. California Co.,* 114 F. (2d) 980 (C.C.A. 10, 1940).

([10]) *General Utilities & Operating Co. v. Helvering,* 296 U. S. 200, 80 L. ed. 154 (1935) (syl. 2); *Helvering v. Savage,* 297 U. S. 106, 80 L. ed. 511 (1936) (syl. 1); *Tulsa Tribune Co. v. Comm'r.,* 58 F. (2d) 937 (C.C.A. 10, 1932); *Covington v. Comm'r.,* 103 F. (2d) 201 (C.C.A. 5, 1939); *Schoenfeld v. Comm'r.,* 103 F. (2d) 964 (C.C.A. 9, 1939); *Rhodes v. Comm'r.,* 111 F. (2d) 53 (C.C.A. 4, 1940; *Phillips v. Comm'r.,* 112 F. (2d) 721 (C.C.A. 3, 1940); and *Helvering v. Achelis,* 112 F. (2d) 929 (C.C.A. 2, 1940). For countless authorities in accord, see American Digest System, "Internal Revenue", Key number 1603—and, in earlier series, Key number 25.

tify the Commissioner's belated action, we submit he is barred from relying upon his regulations.

In the second place, we agree with taxpayer's contention in the Cannon case (rejected by the court—129 F. (2d) at 648) that Section 43 does not warrant regulations requiring initial submission to the Commissioner's discretion of the question of "clearly reflecting income". Section 41 expressly invokes "the opinion of the Commissioner". Section 42 probably incorporates this by reference. The absence of comparable language in Section 43 is, in our opinion, of controlling significance.

In any event, as the dissenting opinion points out in the case at bar (R. 1), there was no occasion or justification for petitioner's claiming these deductions in post-1935 returns when the deduction had already been taken in its 1935 return as accrued processing tax liability. Compare the following language from the Cannon opinion (129 F. (2d) at 648, 649):

> "The taxpayer had secured the benefit of the entire deduction in its return for 1935. It originated no movement, before the Commissioner or otherwise, to change this situation. The Commissioner disturbed the situation by a redetermination of the tax for 1935 through elimination of this deduction item. . . .
>
> "Another controlling consideration is that these reimbursements are an intimate part of a definite transaction which the Commissioner is himself opening up. The matter opened up by the Commissioner here is the processing tax transactions of the taxpayer in May and June, 1935. The amount of such taxes was included in gross income and offset by the deductions for taxes in the return with the net result that they had no effect upon net income. The reimbursements obviously decreased the gross income by that much. If reduction by the reimburse-

ments is entirely disallowed it is obvious that the net income will be improperly increased to the amount of the reimbursements, although they are an intimate part of the transaction affecting the net income and the entire situation as to these taxes as reflected in 1935."

Finally, *lex neminem cogit ad vana seu inutilia peragenda*—"the law forces no one to do vain or useless things". In the Cannon case (129 F. (2d) at 649) the court excused compliance with this regulation because attached to the Commissioner's deficiency notice was a statement that reimbursements could not be related back unless there were a prior definite agreement. This statement, said the court:

> "'. . . includes a direct ruling by him [Commissioner] that such reimbursements would not be considered in the adjustment unless 'a definite agreement to settle or compromise such claims was entered into with such vendees *during the taxable year here under consideration.*'" (Italics added).

From this the court concluded:

> "Therefore, the situation was that before the notice of redetermination there was no occasion for the taxpayer to comply with the regulation and after such notice the futility of such compliance was made definite by the Commissioner. An attempt to comply with the regulation, after the notice, would have been an idle gesture without result or effect upon the situation."

Exactly the same thing is true here. Although the notice of deficiency in the case at bar does not contain a statement of the Commissioner's attitude toward reim-

bursements, none was necessary. Long prior to receipt of the instant deficiency notice, petitioner was fully informed of the Commissioner's attitude and knew that, absent an express agreement in 1935 to make reimbursements, no deduction therefor would be allowed.

Had we anticipated the Commissioner intended to rely upon noncompliance with Regulations 86 we could have introduced evidence to show that immediately after the A. A. A. was declared unconstitutional (and both before and after enaction of Title III) petitioner's counsel commenced negotiating with the Commissioner concerning customer reimbursements and the treatment of the tax deduction. Numerous conferences were held in Washington. Petitioner submitted to the Commissioner lengthy written briefs on the precise issues here involved (see Record, p. 36, 37, for recognition by the Board below that such conferences occurred). Even prior to the filing of petitioner's 1936 return the Commissioner had taken the adamant stand that reimbursements could not be related back to 1935 unless definite agreements to make refunds were entered into during that year. Under *Hormel v. Helvering, supra,* 312 U. S. 552, and *Helvering v. Richter, supra,* 312 U. S. 561, no estoppel should be predicated upon petitioner's noncompliance with Regulations 86—an issue raised by the Commissioner for the first time in its Brief on appeal to the Tenth Circuit Court —without affording petitioner an opportunity of proving the known futility of appealing to the Commissioner's discretion.

Furthermore I. T. 3086, XVI-24-8756 (1937 C. C. H. *Federal Tax Service,* par. 6361, 6-23-37) and I. T. 3090, XVI-25-8769 (1937 C. C. H., *supra,* par. 6378, 7-1-37) are themselves positive proof that prior to the instant deficiency determination of June 21, 1937 (R. 19) the

Commissioner had gone on record as allowing the relation back of reimbursements *only* in event they were paid or contracted to be paid ("accrued") in 1935:

> " . . . the entire amount of the selling price received from the purchasers for the commodities in respect of which the taxes were imposed, including any addition to the selling price as the result of such taxes, must be included in computing gross income, *unless during the taxable year the taxpayer rebated, or was under a legal contractual obligation to rebate,* to the purchasers the addition to the selling price on account of such taxes." (I. T. 3086; italics ours).

Also, G. C. M. 20134, 1938-22-9360 (1938 C. C. H. *Federal Tax Service,* par. 6313, 6-8-38) proves conclusively that any attempt at compliance with Regulations 86 would have been to no avail. Here, exactly as in the Cannon case, it is undeniable that:

> "An attempt to comply with the regulation, after the notice [or before ! !] would have been an idle gesture without result or effect upon the situation."

In addition, we reiterate that the Commissioner has never yet denied petitioner's contention *on the ground* that accounting for the reimbursements in the years of payment clearly reflects income. Before the Board below he maintained the reimbursements could not be accounted for in 1935 *because* (a) no liability to make them accrued in 1935, and (b) Section 43 does not apply to prior, but only to subsequent taxable periods. He maintained that *irrespective of whether accounting for the reimbursements in the years of payment distorted taxpayer's true income* no relation back was permissible. He took much the same position in his brief to the

Tenth Circuit Court, and the decision of that Court likewise evades consideration of the "clear reflection of income" issue. In short, the Commissioner's position throughout has been that neither Section 43 nor any other statute or decision authorizes the taking of a deduction in a year prior to its accrual as a liability. This, he has maintained, is an inexorable rule of law. Unless a deduction is either paid or accrued within the taxable year, under no circumstances may it be accounted for in that period. The opinion of the Tenth Circuit Court adopted this position in reversing the Board's decision. Therefore, not only has the Commissioner failed to exercise his (alleged) "discretion" of determining petitioner's accounts fail properly to reflect income, and failed to adopt or urge this ground for rejecting petitioner's contention, (11) *but he has even denied he possesses any such discretion*—and the Tenth Circuit Court has agreed with him. Since the Commissioner (and the Tenth Circuit Court) takes the flat position that even to avoid distortion of income it is not permissible, under Section 43 or otherwise, to violate the "annual accounting principle" by taking a deduction in an earlier period than that in which it is paid or accrued, how can it be denied that taxpayer's compliance with Regulations 86 would have been futile? Why seek the Commissioner's determination that relation back of the rebates to 1935 is essential to true income reflection when it was known then and has since been confirmed by his contentions throughout this case that he would have refused to consider this accounting fact, but, instead, would

(11) This fact is itself sufficient to preclude the Commissioner's reliance herein upon taxpayer's failure to comply with the regulation: *Carondelet Bldg. Co. v. Fontenot*, 111 F. (2d) 267, 269 (C.C.A. 5, 1940).

have peremptorily denied the request for the reason no liability to reimburse accrued in 1935?

It is submitted that Regulations 86 can play no proper part in the determination of the instant controversy.

II.

THE TENTH CIRCUIT COURT'S OPINION IS ERRONEOUS FOR THREE ADDITIONAL REASONS.

The fundamental issue for determination herein—whether the vendee reimbursements may be taken in 1935, under Section 43, in order clearly to reflect income—has already been discussed. We wish, however, to urge three additional grounds in opposition to the decision of the Tenth Circuit Court of Appeals.

A. $106,604.02 of Petitioner's Gross Receipts for 1935 Did Not Constitute "Income" Until 1937 When Controversies as to Ownership Thereof Were Determined.

This contention was thoroughly briefed and argued to the Board. An excellent summary of petitioner's position is contained in the first portion of the Board's opinion (R. 40-41), and will not, for that reason, be restated here. For the authorities relied upon by petitioner, in addition to *Comm'r. v. Brown*, 54 F. (2d) 563 (C. C. A. 1, 1931), *cert. den.* 286 U. S. 556, 76 L. ed. 1291, see *Gugenheim Exploration Co. v. U. S.*, 238 Fed. 231, 237 (S. D., N. Y., 1917) and 1 Paul & Mertens, *Law of Federal Income Taxation* (1935), § 5.09, p. 111 (for authority that "receipts" are not synonymous with "income"); Roswell Magill, *Taxable Income* (1936), p. 181, and 1 Paul & Mertens, *supra*, § 11.23, p. 503 (for authority that monies received are not income if, and so long as, any "substantial contingency" remains that they may not be retained); and, in general, *Comm'r. v. Tur-*

ney, 82 F. (2d) 661 (C. C. A. 5, 1936). It should be particularly noted that petitioner refused to exercise dominion over these funds, and that it never denied the right of vendees to reimbursements (although it resisted two abortive law suits, which interfered with its attempts to reach amicable agreements with the majority of its vendees, *upon purely technical grounds*—R. 35).

B. The Uniqueness and Enormity of the Instant Problem Justifies Consideration of This Case as Involving a Single, Continuous Transaction, Correlating Gross Income and Reimbursements Accordingly.

This contention was briefed before the Board, and the Tenth Circuit Court, but is not mentioned in either opinion. The extraordinary, sui generis nature of the instant problem has already been emphasized herein. Because of its uniqueness and enormity, and because it is so unlikely to recur, we feel an exception to the "annual accounting period" rule should here be made in the interests of justice. All the relevant facts of this case are *in fact* part and parcel of one continuing transaction instigated by the A. A. A., aggravated by the statute's adjudicated unconstitutionality, protracted by enactment of Title III, complicated by conflicting claims and interests of vendees and the Government, and culminating in customer reimbursements. "Both the deductions", says the court in the Cannon case (129 F. (2d) at 646, "and the reimbursements relate to the same transaction in 1935." Therefore, under the peculiar circumstances herein, we submit the "transaction" approach may be applied. In support, we refer This Court to *Bowers v. Kerbaugh-Empire Co.*, 271 U. S. 170, 70 L. ed. 886 (1926.) Compare, *Comm'r. v. Darnell*, 60 F. (2d) 82 (C. C. A. 6, 1932), and *George G. Moore*, 19 B. T. A. 364 (1930).

C. The 1935 Tax Deduction Should Not Be Disturbed Irrespective of the Fact That the Taxing Statute Was Subsequently Held Unconstitutional.

Although the authorities on this proposition are not harmonious, there is respectable authority holding that the deduction properly taken in petitioner's 1935 income tax return for accrued processing tax liability cannot be disallowed merely because the taxing statute was subsequently declared unconstitutional and the tax was therefore never paid: *Davies' Estate v. Comm'r.*, 126 F. (2d) 294 (C.C.A. 6, 1942), and *J. H. Dougherty's Sons, Inc. v. Comm'r.*, 121 F. (2d) 700 (C. C. A. 3, 1941).

This contention was not raised by petitioner before the Board for the reason that the cited authorities had not then been decided. However, since it *supports* (pro tanto) the Board's denial of the tax deficiency, this is no obstacle to petitioner's raising the issue, as was done, before the Tenth Circuit Court of Appeals (*Helvering v. Gowran*, 302 U. S. 238, 82 L. ed. 224, 1937; *Rhodes v. Comm'r.*, 111 F. (2d) 53, C. C. A. 4, 1940). Also, that the Davies and Dougherty decisions were not rendered until after submission of the present case to the Board of Tax Appeals, would seem an "exceptional circumstance" within the rule enunciated by *Hormel v. Helvering, supra*, 312 U. S. 552, and *Helvering v. Richter, supra*, 312 U. S. 561.

This issue also was not mentioned in the Tenth Circuit Court's opinion despite its being urged in petitioner's brief (and renewed in its petition for rehearing).

CONCLUSION.

The outstanding single fact in this case—that petitioner's income for 1935 cannot be truly reflected save by accounting for its vendee reimbursements in that year—has never been denied by the Commissioner and is not controverted by the instant decision of the Tenth Circuit Court of Appeals.

This is a purely factual issue which the Board of Tax Appeals has determined in favor of petitioner.

Section 43 of the 1936 Revenue Act expressly provides for the taking of deductions in a year other than that of payment or accrual wherever necessary in order clearly to reflect income.

Therefore it is submitted that the judgment of the Tenth Circuit Court of Appeals herein is erroneous, is in direct conflict with the decision of the Eighth Circuit Court of Appeals in the Cannon Valley Milling Case, and should be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The case involves an income tax question, arising as an aftermath to the invalidation of the processing taxes imposed by the Agricultural Adjustment Act. The taxpayer, a manufacturer and seller of wheat flour, is on the accrual basis. In 1935, it increased the prices of its flour to include the amount of the tax. During that year, however, it obtained a temporary injunction against further collection of the taxes on the condition that it file returns and pay the amounts shown to be due to a designated depository. The Agricultural Adjustment Act was declared un-

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constitutional January 6, 1936 (*United States* v. *Butler*, 297 U. S. 1); thereafter the injunction was made permanent and the impounded taxes were returned to the taxpayer. In 1936, 1937, and 1938, a part of the refunded taxes was voluntarily returned by the taxpayer to its vendees. The primary question presented by the petition is whether the taxpayer is entitled to deduct from its gross income for 1935 these payments to customers which it made in 1936, 1937, and 1938.

Section 43 of the Revenue Act of 1934, c. 277, 48 Stat. 680, provides that deductions shall be taken in the taxable year "in which 'paid or accrued' * * *, dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." The taxpayer claims the right to take the deduction in 1935 by virtue of the "unless" clause in this section. The court below reversed the Board of Tax Appeals and sustained the Commissioner in denying this claim.

We think the decision below is correct. In a similar case, however, the Circuit Court of Appeals for the Eighth Circuit has held for the taxpayer. *Commissioner* v. *Cannon Valley Milling Co.*, 129 F. 2d 642. The court below (R. 68–69) correctly pointed out that the two cases are distinguishable in the degree of proof offered by the

taxpayer to show a distortion of income, and declared no rule of law contrary to the *Cannon Valley* decision. Nevertheless, it is fairly arguable that the two cases are basically inconsistent since they apply Section 43 differently in similar situations.[1]

It is perhaps doubtful that the Court will deem this an appropriate case for certiorari, but we do not oppose the granting of the writ.

Respectfully submitted,

CHARLES FAHY,
Solicitor General.

SEPTEMBER 1943.

[1] The same question is pending before the Circuit Court of Appeals for the Third Circuit in *Commissioner* v. *Blaine, Mackay, Lee Co.*, Nos. 8109, 8110.

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CITATIONS

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinions of the United States Board of Tax Appeals (R. 32–49) are reported in 45 B. T. A. 671. The opinions of the Circuit Court of Appeals (R. 61–71) are reported in 135 F. 2d 165.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 6, 1943. (R. 72.) A petition for rehearing was denied on May 22, 1943. (R. 73.) The petition for a writ of certiorari was filed on August 21, 1943, and was granted on October 11, 1943 (R. 74). The jurisdiction of this

Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under Sections 23 (a), 41 and 43 of the Revenue Act of 1934 the taxpayer is entitled to deduct from its gross income for 1935 payments aggregating $45,865.90 which it made to certain of its customers in the years 1936, 1937 and 1938.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 38 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> SEC. 41. GENERAL RULE.
>
> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 43–1. *"Paid or incurred" and "paid or accrued."*—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in

his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

STATEMENT

This case involves petitioner's liability for income and excess profits taxes for the year 1935. The facts as found by the Board of Tax Appeals may be stated as follows:

The taxpayer is a corporation organized under the laws of Kansas, with its principal place of business at Abilene, Kansas, engaged in the manufacture and sale of wheat flour. It reported its net income on the accrual basis of accounting. As a first domestic processor of wheat it was subject to the processing tax levied under the Agricultural Adjustment Act. (R. 34.)

During the period from January 1, 1935, to May 1, 1935, the taxpayer paid to the Collector of Internal Revenue certain processing taxes and claimed and was allowed the amount so paid as a deduction from gross income in its federal income tax return for the year 1935. The amount so paid is not in issue herein. (R. 34.)

On June 29, 1935, the taxpayer instituted a suit in the District Court for the District of Kansas seeking to enjoin the further collection of processing taxes levied under the Agricultural Adjustment Act. A temporary injunction was granted on July 24, 1935, effective from May 1, 1935, enjoining the further collection of the processing tax, on condition that, pending the final determination of the constitutionality of the Agricultural Adjustment Act, the taxpayer file information returns with the Collector and deposit in a bank, designated as the depository of the court, a sum of money equal to the tax shown to be due by the information returns. During the period from May 1 to December 31, 1935, the taxpayer paid into the depository a total of $93,974.40. In addition it accrued upon its books the sum of $9,896.66 as a liability for the processing tax for the last month of the period, plus an additional item of $1,183.64 representing a reserve for possible increases in the processing tax for prior years, but these latter two items were not paid to the Collector or to the depository. (R. 34.)

On January 6, 1936, the taxing provisions of the Agricultural Adjustment Act were held unconstitutional. *United States* v. *Butler,* 297 U. S. 1. Thereafter certain of the taxpayer's vendees filed intervention petitions in the injunction proceeding seeking to have the impounded money returned to them. The taxpayer resisted these petitions upon technical grounds and they were

denied on February 28, 1936. On the same day the District Court entered an order making permanent the temporary injunction theretofore granted and directing the depository to pay over to the taxpayer the $93,974.40. This amount was paid over to the taxpayer on February 28, 1936. (R. 34–35.)

The taxpayer's sales of flour from May 1 to December 31, 1935, were made at a stated price per barrel. The selling price consisted of the usual items of cost, plus normal profit, and included in addition an amount sufficient to cover the processing tax. The invoice reflected the contract price, but did not show the tax as a separate item. The contract price was included in the gross sales entered on the taxpayer's books. More than 50 percent of such sales were made under the Miller's Federation Uniform Sales Contract. (R. 35–36.) The pertinent reference to processing taxes in the contract is as follows (R. 36):

> The price named in this contract includes all taxes as at the date hereof proclaimed by the Secretary of Agriculture by virtue of the authority vested in him by the Agricultural Adjustment Act. * * * Under said Act it is provided that said taxes may be changed from time to time. It is recognized * * * that there is a growing tendency on the part of the United States and the separate states to tax grain * * * used in connection with the man-

> ufacturing, processing, blending, sale or distribution thereof. It is therefore, agreed * * * that if, after the date of this contract, the commodities * * * used in connection with the manufacturing, processing, blending, sale or distribution thereof, shall become subject to any increase in taxes or to any new or additional tax or taxes other than those included in the price hereof, (if the seller shall be required by law to collect such increases or additional taxes) * * * said increases or additional taxes shall be added to the price hereof; and correspondingly if any tax included in the price hereof shall be decreased or abated, then in that event, said decrease or abatement shall be deducted from the price hereof.[1]

The taxpayer considered this provision of the Miller's Federation Contract to be applicable only to increases or decreases in the price between the date of the order and the date of shipment and as not creating any obligation to refund part of the price in case of invalidation of the Agricultural Adjustment Act. (R. 37.)

Following the receipt by the taxpayer of the impounded money from the depository, certain of its vendees instituted suit against it, claiming to be entitled to $1.38 per barrel of flour purchased

[1] The deletions have somewhat distorted the sense of this provision. For a fuller quotation see *Moundridge Milling Co.* v. *Cream of Wheat Corp.*, 105 F. 2d 366, 367, fn. 4 (C. C. A. 10th).

by them during the injunctive period. The suits were based upon the Miller's Federation Contract and upon quasi-contractual and equitable trust fund theories. The suits were resisted and ultimately dismissed. (R. 35.)

As early as July, 1935, the taxpayer had been advised by counsel that if the Agricultural Adjustment Act should be held invalid the Government intended to recapture by new legislation a large part of the unpaid processing taxes and that it would therefore be inadvisable for the taxpayer to make any commitments to refund any definite amount or any percentage of the tax to its customers. On June 22, 1936, Congress enacted the Revenue Act of 1936, which provided in Title III for the imposition of the unjust enrichment tax and in Title VII for the refund of taxes paid under the Agricultural Adjustment Act. The taxpayer's counsel sought a ruling by the Treasury Department on the question whether the Miller's Federation Contract was an agreement, within the meaning of Title III, entitling the taxpayer to credit against its taxes under that title for refunds made to vendees. In the meantime counsel continued to advise the taxpayer not to make any definite commitments to its customers with reference to refund of the processing tax to them. (R. 36.)

Pursuant to this advice the taxpayer refrained from making any definite promises respecting refunds in all written communications to its vendees.

Through its officers, salesmen and brokers it orally informed some of them that it proposed to make an agreement with them as soon as all matters with respect to the impounded funds and unpaid taxes should be finally settled. It was stated that the taxpayer would treat them fairly and do as well by them as other mills similarly situated, but that no promise could be made to refund any definite amount to them. (R. 37.)

In November 1936, the taxpayer informed some of its vendees who had purchased flour under the Miller's Federation Contract that it intended to seek a final determination of its tax liability by the Treasury Department, and, after the amount of unpaid processing taxes passed on to vendees on which it would be subject to tax had been fixed, that it would seek permission to refund the whole of such amount to vendees, provided the Department would accept such repayment as an offset against unjust enrichment (Title III of the Revenue Act of 1936), income and excess profits tax liabilities, and provided the vendees would accept such amount in satisfaction of their claims. Later in 1936, the taxpayer was informed by its counsel that the Treasury Department had agreed to allow credit for reimbursements and it should proceed to make settlements with its vendees. The taxpayer thereupon commenced negotiations with some of its vendees and made agreements with some of them as to the amount to be repaid to them. (R. 37.)

During 1936, 1937, and 1938 drafts in various amounts were issued by the taxpayer to the vendees with whom agreements were made, aggregating (together with credits against the accounts of some of them) $45,865.90 ($2,475.03 in 1936, $41,879.50 in 1937, and $1,511.37 in 1938). Attached to each draft and made a part of it was a "Release Agreement," which, after referring to the difficulty of determining the exact amount of the processing tax which had been borne by the vendor and the vendee, recited that "the amount of the taxes shifted to vendee * * * was not more, and may be less than" the total of the draft and credit memorandum referred to in the agreement. By cashing the draft the vendee acknowledged full payment and satisfaction of, and discharged the vendor from, all demands, charges, claims, actions, and rights of action growing out of amounts paid on account of processing tax during the injunctive period and included in or added to the price of flour sold by the vendor to him; covenanted that he was the actual purchaser of the flour and the owner of the claim, that he was not a party to any pending action against the vendor, and that he had not authorized the institution or prosecution of any suit or action against it. The agreement also stated that nothing therein was to be construed as, or constitute an admission of, liability of the vendor to any other person, firm, or corporation and that all legal and equitable defenses, of which it might

be possessed, in any and all pending and future litigation against it, were expressly reserved. (R. 37–38.)

The taxpayer did not make refunds to all who had purchased flour from it during the injunctive period. Refunds were made to some customers who had purchased under the Miller's Federation Contract, irrespective of whether or not they had been promised fair treatment. In making refunds only regular customers were considered, and a large number of casual customers, or customers toward whom the petitioner felt no obligation, were ignored. The petitioner made no attempt to effect settlements with those to whom the promises to treat fairly had been made but who had not purchased under the Miller's Federation Contract. (R. 38.)

On a schedule attached to the taxpayer's income tax return for the year 1935, the amount of $908,613.29 was shown as "Gross sales, per Books". From this it deducted $106,604.02 as "Provision for allowances to Vendees of Processing Taxes" and added $103,887.54 representing accrued processing taxes which had not been paid. The resulting figure of $905,896.81 was reported as "Net Sales." The taxpayer had arrived at the amount of $908,613.29 as representing its gross sales in the following manner: From its total gross sales of $1,072,139.50, it deducted $163,526.21 representing estimated processing taxes collected from vendees during the year; this in-

cluded, among other items, the $93,974.40 impounded in the depository and the $9,896.66 accrued upon the taxpayer's books as processing taxes for the month of December 1935, but not impounded or paid over to the Treasury Department. (R. 38–39.)

The Commissioner disallowed as a deduction $105,054.70, consisting of the following items (R. 39):

Processing taxes impounded and later (Feb. 1936) released to petitioner	$93,974.40
Accrued processing taxes Dec. 1935. Not impounded or paid over to treasury	9,896.66
Estimated processing reserve set up to provide for additional assessments for prior years	1,183.64
	105,054.70

The petition filed by the taxpayer with the Board of Tax Appeals assigned error in the disallowance of $101,783.89 of the above amount as a deduction. (R. 39.)

The income tax returns of the taxpayer for the years 1936 and 1938 are not in evidence, and the record does not show whether the payments to customers of $2,475.03 and $1,511.37 in those years were claimed as deductions, or whether they were allowed or disallowed by the Commissioner. The taxpayer's return for 1937 shows a net loss of $66,944.25, computed by including in the deductions claimed the sum of $43,390.87 representing payments to customers in that year in settlement of processing tax claims. (R. 39.)

The Board of Tax Appeals held (five members dissenting) that the taxpayer was entitled to deduct from its gross income for the year 1935 the $45,865.90 which it had paid to its vendees in the years 1936, 1937 and 1938. (R. 32–49.) The Circuit Court of Appeals (one judge dissenting) reversed the Board's decision, holding the taxpayer was not entitled to any deduction. (R. 61–71.)

SUMMARY OF ARGUMENT

The taxpayer is not entitled to deduct from its gross income for 1935 the payments which it made to its customers in 1936, 1937, and 1938. Assuming that the item was a business expense within the meaning of Section 23 (a), it plainly was neither paid nor incurred in 1935. It has long been well settled that a deduction may not be accrued so long as it remains contingent, but only when the fact of liability becomes fixed and absolute. This is of course but one illustration of the basic principle upon which our system of income taxation rests, *i. e.*, each tax year stands alone; the tax for one year is separate from that of any other.

The "unless" clause of Section 43 does not constitute an exception to this principle. That clause must be read as part of the entire statute, and it therefore permits the taking of a deduction in a year other than that in which the item is paid or incurred, *only when consistently with the annual nature of the tax* it is necessary to do so in order "to clearly reflect the income." It

thus applies to cases in which an item of expense such as interest or rental for a series of years is paid in a single year. The clause is not to be read as permitting departure from the system of separate fixed periods of return for the purpose of ascertaining the net result of particular transactions or the final outcome of a prior taxable period.

The "unless" clause must necessarily be read in harmony with the principle of separate annual periods, for that is the only standard afforded by the statute to determine whether income is "clearly reflected." While it is true that from the point of view of a particular transaction which extends over a period of several years, the effects of that transaction may be distorted by treating each year as a separate unit, it is equally true that from the point of view of the annual system the income of each of those years is distorted by grouping the effects of the transaction into a single year. It is impossible therefore to speak of the necessity of avoiding distortion of income unless the criterion has been fixed against which the alleged distortion must be measured. And the only standard available is that afforded by the cornerstone of the entire statute. What must not be distorted is the income for each year, viewed as separate units.

Our construction of Section 43 is supported not only by the words of the statute, but by its legis-

lative history and by the decisions of this Court. Moreover a contrary construction would upset long established principles of tax accounting and would raise problems which are hardly soluble within the framework of the statute.

Even if it be assumed that the "unless" clause of Section 43 introduces a transaction theory of taxation, it is nevertheless not applicable here. The payments which the taxpayer made in 1936, 1937 and 1938 were made only to regular customers and a large number of other customers were ignored. In no sense were these payments a cost of producing the 1935 income; they looked more to the future than to the past.

ARGUMENT

THE TAXPAYER IS NOT ENTITLED TO DEDUCT FROM ITS GROSS INCOME FOR 1935 THE PAYMENTS WHICH IT MADE TO ITS CUSTOMERS IN 1936, 1937, AND 1938

1. In the years 1936, 1937, and 1938 the taxpayer paid to some of its customers amounts totaling $45,865.90. It seeks to deduct this item from its gross income for the year 1935 under Section 23 (a) of the Revenue Act of 1934, *supra*, which allows the deduction from gross income of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Assuming that the item was a business expense within the meaning of

this provision[2] and thus was deductible at some time, it was plainly neither paid nor incurred during 1935. It is well settled that taxpayers on the accrual basis of accounting may not accrue a deduction until the fact of liability becomes fixed and certain. *Lucas* v. *American Code Co.*, 280 U. S. 445; *North American Oil* v. *Burnet*, 286 U. S. 417, 424; *Brown* v. *Helvering*, 291 U. S. 193; *Dixie Pine Products Co.* v. *Commissioner*, No. 84, this Term. Here the taxpayer not only successfully took the position that the Miller's Federation Contract imposed no obligation upon it to make refunds to its vendees,[3] but following the advice of counsel it carefully refrained from making any commitment to them throughout the year 1935.[4]

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[2] It is arguable that at least to the extent that the payments were made to keep the good will of the customers, they are not deductible at all under *Welch* v. *Helvering*, 290 U. S. 111. See the dissenting opinion of Judge Thomas in *Helvering* v. *Cannon Valley Milling Co.*, 129 F. 2d 642, 649 (C. C. A. 8th). We refrain from pressing the point, however, in view of the ruling of the Bureau of Internal Revenue in G. C. M. 20134, 1938–1 Cum. Bull. 122.

[3] The taxpayer was correct in its interpretation of the Miller's Federation Contract. See *Moundridge Milling Co.* v. *Cream of Wheat Corp.*, 105 F. 2d 366 (C. C. A. 10th); *Johnson* v. *Igleheart Bros.*, 95 F. 2d 4 (C. C. A. 7th), certiorari denied, 304 U. S. 585.

[4] The taxpayer urged before the Board of Tax Appeals that the promises which it had made to some of its vendees to treat them fairly had constituted an acknowledgment of liability on its part. But the Board found that this was not the fact. The Board said (R. 42):

"* * * We do not agree with this contention. The so-called 'treat fairly' agreements were no more than assurances

The requirement in Section 23 (a) that expenses be deducted in the year in which they are paid or incurred is, of course, but an expression of the fundamental principle upon which our system of income taxation is based, *viz*, that taxes are imposed "for annual periods, and the exaction for one year is distinct from that for any other". *Tait* v. *Western Md. Ry. Co.*, 289 U. S. 620, 624. Each year stands alone. The principle is fundamental and has been announced in numerous cases, e. g., *Lucas* v. *American Code Co.*, 280 U. S. 445; *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 306; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 326; *Brown* v. *Helvering*, 291 U. S. 193; *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493, 498; *Heiner* v. *Mellon*, 304 U. S. 271, 275, 276.

In *Lucas* v. *American Code Co., supra*, the taxpayer employed one Farquahar as sales manager for 18 years from January 3, 1919, the compensation to be a commission based on sales. In May 1919 it discharged him. Farquahar brought suit in July 1919 and the taxpayer defended, denying liability. The company, which was on the accrual

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given by petitioner to its customers to retain their good will. The testimony of petitioner's officers indicates that they did not intend to bind petitioner to make any repayments to its vendees."

As the taxpayer has conceded, the Board's determination on this point is conclusive.

basis of accounting, set up a reserve on its books for the year 1919 equal to the commissions for that year and sought permission from the Commissioner to deduct the reserve in its return for 1919. The permission was refused. In 1922 judgment on Farquahar's suit was entered against the taxpayer and in 1923 the judgment was affirmed on appeal and paid. The taxpayer contended that it was entitled to deduct the amount of the judgment from its income for 1919, but the Court rejected the contention on the ground that it conflicted with the principle of separate annual periods.

In *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, the taxpayer was engaged from 1913 to 1915, inclusive, in carrying out a dredging contract with the United States. In its income tax returns for 1913 to 1916, the taxpayer added to gross income the payments made under the contract during each taxable year and deducted its expenses paid that year in performing the contract. The total expenses of the work far exceeded the total receipts, and the tax returns for 1913, 1915 and 1916 showed net losses, while that for 1914 showed net income. Work under the contract was abandoned in 1915, and in 1916 suit was brought against the United States to recover damages on the ground that the material to be dredged was not as represented in the contract. Final judgment was entered for the claim-

ant in 1920, under a holding that the recovery was upon the contract and was compensatory of the cost of the work. The sum received by the taxpayer in 1920 under the judgment equaled the amount by which the expenses under the contract had exceeded the receipts from it, plus accrued interest. In other words, the effect of the judgment was merely to make the taxpayer whole, and not to produce any profit to it on the dredging contract. The Circuit Court of Appeals had held that the amount of the judgment (exclusive of that part which represented interest) should be excluded from gross income for 1920 on condition that amended returns be filed for the years 1913 to 1916 from which were to be omitted the deductions of the related items of expense paid in those years. This Court reversed, stating the question to be (pp. 362–363):

> * * * whether the gain or profit which is the subject of the tax may be ascertained, as here, *on the basis of fixed accounting periods,* or whether, as is pressed upon us, *it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.* [Italics supplied.]

The Court stated (p. 363) that all of the Revenue Acts uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during the fixed accounting period of the calendar or fiscal year, either

upon a cash or an accrual basis, depending upon the method used. The amount of the judgment was held to be properly includible in the return for 1920 regardless of whether the particular transaction resulted in a net profit, because (pp. 364–365):

> Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. *The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.*
>
> * * * * *
>
> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely *whether the final outcome of the period, or of a given transaction,* will be a gain or a loss. [Italics supplied.]

The underlying reasons for the adoption by Congress of the annual system were stated as follows (p. 365):

> It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

2. It is not denied by the taxpayer that its position collides directly with this basic principle of our system of income taxation. It is contended however that the departure is permissible in the instant case because (a) where the deductions of one year are closely related to the income of an earlier year, Section 43 allows the deductions to be referred back to the earlier year in order "to clearly reflect the income," and (b) there was here such a close relationship between the payments in 1936–1938 and the income for 1935 that there should be a relation back of the deductions. We submit that there is no merit in either of these points.[5]

(a) Section 43 of the Revenue Act of 1934 provides:

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[5] This is not a situation where the relation back may be justified for the purpose of correcting a mistake. In such cases other considerations may apply. See Brief for the Respondent in *Dixie Pine Products Co.* v. *Commissioner*, No. 84, this Term.

> The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

The taxpayer relies upon the "unless" clause of this section, contending that it is the purpose of this clause to countenance departures from the annual system. We agree that it is the purpose of the clause to allow deductions to be taken in a year other than that of payment or accrual, but we do not think that it goes so far as to countenance a departure from the annual system.

There are two possible constructions of the section: First, that it is to be read in harmony with the remainder of the statute; thus it permits the taking of a deduction in a year other than that in which the item is paid or incurred, *only when consistently with the annual nature of the tax* it is necessary to do so in order "to clearly reflect the income." Second, that the section is to be read as a denial of the annual system; thus it permits ignoring the fixed periods of return for the purpose of ascertaining the net result of particular transactions or the final outcome of a prior taxable period. We think that the first is the true meaning of the section. Not only must the section necessarily be read as part of the en-

tire statute, but its legislative history and the decisions of this Court support this view.

Section 43 with the "unless" clause first appeared in the revenue laws as Section 200 (d) of the Revenue Act of 1924, c. 234, 43 Stat. 253. The report of the House Ways and Means Committee [H. Rep. No. 179, 68th Cong., 1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) 241, 249)] stated:

> In subdivision (d) of this section authority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which "paid" or "accrued" when, in his opinion, it is necessary in order to clearly reflect the income. The Revenue Act of 1921 in sections 214 (a) 6 and 234 (a) 4 authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

The report of the Senate Finance Committee is to the same effect. See S. Rep. No. 398, 68th Cong.

1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) 266, 273). It will be observed that the committee reports specifically state that: "The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years."

It is apparent that there is a wide difference between the type of case referred to in the committee reports as the kind which Section 43 was designed to meet, and one in which, as here, the deduction is sought to be thrown into another year simply because an ancestor transaction took place then. To allow the proration of a repayment of interest, or rental, or the like, over the period covered by the payment is not inconsistent with the annual nature of the tax. Such payments bear a great deal of similarity to capital expenditures, and a direction that in order to avoid distortion they be amortized over the period of years covered by the payment is not a denial but is, on the contrary, a recognition of the principle of separate fixed periods of return.

Section 43 must be read as part of an entire statute whose cornerstone is a system of separate fixed periods of return not only because it *is* a part of the statute, but, in fact, upon close analysis, any other construction seems to be impossible. The committee reports speak of the necessity of this provision in order to avoid "distortion" of income. In *Helvering* v. *Cannon Valley Milling Co.*, 129 F. 2d 642 (C. C. A. 8th), the court, and

in the instant case the taxpayer, lean heavily upon the proposition that it is necessary to relate the deduction back to the earlier year in order to prevent "distortion" of income. But distortion means departure from the norm, and it is impossible to tell whether there has been a deviation unless there is a standard by which to measure. The only criterion available is that afforded by the entire statute, namely, that each year is a separate period. And as was pointed out in the *Sanford & Brooks* case (p. 365) it is fundamental that under such a system there may be income subject to tax in one year, even though when the operations of that year are combined with those of other years the result is a loss. Viewed from the standpoint of the total operations over the period of years there may be a distortion in attributing income to one of those years; but viewed from the standpoint of each year there is no distortion. And so in the instant case it is *only by viewing all of the years as together constituting a single period* that it is possible to say that there is a "distortion" of income unless the payments made in 1936, 1937 and 1938 are related back to 1935.[6] But there is

[6] We think that even if Section 43 be construed to permit the fixed periods of return to be ignored for the purpose of determining the result of particular transactions, the deduction here may nevertheless not be referred to 1935, for there was no direct relationship between the income for that year and the payments in the later years. See page 33 *infra*.

no warrant in the statute for adopting such a standard. And if, as we submit, each year must be viewed separately, then as one of the dissenting opinions in the Board in the *Cannon Valley* case said (44 B. T. A. 763, 774): "Accounting for 1937 liabilities in 1935 will not clearly reflect 1935 income; it distorts the income of both years."

Indeed, even in the *Cannon Valley* case the majority opinion of the court was unwilling to construe the "unless" clause of Section 43 as introducing the principle that net income is to be computed on the basis of the ascertainment of the net result of particular transactions.

The court recognized the serious and undesirable results flowing from a construction of the clause as an exception to the annual principle; but it was of the view that where application of that principle resulted in "distortion," a departure was permissible. The court said (129 F. 2d 642, 645–646):

> To construe this clause broadly to cover all instances where there is merely some relation between a deductible item and a business transaction in some year other than the one in which it was paid or finally accrued would introduce an uncertainty seriously interfering with the practical administration of tax statutes. Clearly, no such general disturbance of the system was contemplated by section 43. There-

> fore, such relationship alone is not enough. There must be, in addition to such relationship, a situation which clearly convinces that unless such deduction item is transferred there would be a *distortion* of the income of the taxpayer for one or both years, which would amount to an injustice either to the taxpayer or to the Government. We think the guide for construction of this "unless" clause is that it comprehends those exceptional situations where it is necessary to transfer a deduction item in order to avoid such a distortion of income as would produce an injustice. It is this guide we apply to the fact situation here.

However, as we have indicated, to speak of "distortion" as the test by which to measure the applicability of the "unless" clause is to beg the entire question. If the situation is eyed from the point of view of the results of a particular transaction, the effects of the transaction may be distorted by application of the annual principle. But the converse is also true; if the situation is eyed from the point of view of the annual system, the income of each year is distorted by application of the transaction theory. It therefore does not advance solution of the problem to speak of distortion; the question recurs: What is it which must not be distorted but must be clearly reflected? The answer suggests itself: The income of each year, viewed as separate units.

The decisions of this Court support the construction of Section 43 which we urge. In *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115, the taxpayer paid in 1920 additional compensation to certain of its officers for services rendered in prior years. Just as in the instant case the taxpayer was not bound by any prior agreement or legal obligation to make the payments to its vendees in 1936–1938, so in the *Ox Fibre* case (p. 119)—"there was no prior agreement or legal obligation to pay the additional compensation". The Commissioner there contended that he was entitled to allocate the deduction to the previous years in which the services were rendered, relying upon Section 212 (b)[7] of the Revenue Act of 1918, c. 18, 40 Stat. 1057, which contained a provision very similar to that of Section 43. Section 212 (b) of the 1918 Act provided that the net income should be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping his books, but it contained a proviso that "if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income." The Court rejected the Commissioner's contention, holding (p. 120) that "the expense could not be attributed to earlier years, for

[7] This section has been carried forward in all of the later acts. It is now Section 41.

it was neither paid nor incurred in those years." It is to be observed that the problem presented in the *Ox Fibre* case was essentially the same as that here involved: In which year should a deduction be taken in order clearly to reflect income? If the mandate that income must be "clearly reflected" meant that the principle of separate annual accounting periods should be disregarded, then the *Ox Fibre* case would necessarily have been differently decided. Indeed the instant case is *a fortiori,* for there was certainly a closer connection between the income of the earlier years and the payment in the later year in the *Ox Fibre* case than there is in the instant case between the income for 1935 and the payments made in 1936–1938.

In *Brown* v. *Helvering,* 291 U. S. 193, the taxpayer was a general agent for fire insurance companies. His income consisted, among other things, of "overriding commissions" on the business written by local agents in his territory. In the event of cancellation of a policy the taxpayer was required to return to the company a proportionate part of the commission. Thus the commissions received by the taxpayer in any one year were subject to reduction or diminution. Upon the basis of past experience the taxpayer, who was on the accrual basis of accounting, set up a reserve for each of the years from 1923–1926 for the portion of the commissions received in each year which would have to be returned to the companies,

and deducted that reserve from his gross income for each of those years. It is to be observed that the tax years involved in the case were 1923, 1925 and 1926, the latter two of which were years after the advent of Section 200 (d) of the 1924 Act. It was held that the deduction was not allowable. The Court, speaking through Mr. Justice Brandeis, pointed out that taxable income is computed for annual periods; the full amount of the overriding commissions was thus includible in gross income for the year in which they were receivable; however, since a liability cannot be accrued (p. 200) "as long as it remains contingent," but only when it becomes (p. 201) "fixed and absolute," there could be deducted in each year only that portion of the commissions which the taxpayer actually became liable to return in that year.

In *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493, which involved the taxable year 1933, the Court said (p. 498):

> The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be affected by his business transactions of other years. *Burnet* v. *Sanford & Brooks Co.* * * *.

The foregoing are affirmative reasons for reading the "unless" clause of Section 43 harmoniously with the nature of the tax as one imposed

for annual periods. In addition there are weighty reasons against construing the clause as a denial of the annual system and thus permitting the ascertainment of the net result of particular transactions. To so construe Section 43 would mean that *Burnet* v. *Sanford & Brooks Co., supra,* has not been law since the enactment of the 1924 Act, and would cast doubt upon the validity of the regulations which for more than 25 years[8] have afforded to taxpayers optional methods of treating long-term contracts; they may report all the receipts and all the expenditures made on account of a particular contract in the year in which the work is completed, or they may report a part of the income each year upon the basis of percentage of completion. Indeed the effects of such a construction of Section 43 would be felt throughout the entire tax accounting structure.

In a case involving facts precisely like those in *Lucas* v. *Ox Fibre Brush Co., supra,* the deduction would have to be related back to the earlier years, for the compensation which was paid in 1920 was for services rendered in producing the income of the earlier years. Likewise in a situation similar to that involved in *Lucas* v. *American Code Co.,* 280 U. S. 445, the deduction for a judgment ren-

[8] Article 121 of Regulations 33 (1918 ed.); Article 36 of Regulations 45 (1920 ed.); Article 36 of Regulations 62, 65 and 69; Article 334 of Regulations 74 and 77; Article 42-4 of Regulations 86, 94 and 101; Section 19.42-4 of Regulations 103.

dered against the taxpayer would have to be related back to the year in which the cause of action arose. It might even be arguable under such a construction of Section 43 that where property is sold at a loss and the purchaser is to pay in installments, the loss should not be attributable to the year of sale, but should be spread over the period of the installment payments. See *Martin* v. *Commissioner,* 61 F. 2d 942 (C. C. A. 2d), certiorari denied, 289 U. S. 737; *Sacks* v. *Burnet,* 66 F. 2d 223 (App. D. C.).

Moreover, as was observed in the dissenting opinions in *E. B. Elliott Co.* v. *Commissioner,* 45 B. T. A. 82, departure from the principle of the annual system raises additional problems, problems which are hardly soluble within the framework of the statute. Suppose the years to which the deduction is sought to be related back are barred by the statute of limitations. By hypothesis the deduction is not properly to be taken in the later year, for that would result in "distortion." Is the deduction to be denied altogether? Suppose that some of the earlier years are barred by the statute of limitations and some are not. Should the entire amount of the deduction be allocated to those years which are still open, or, if only part of the deduction is to be related back, upon what basis should the allocation be made? The fact that Congress did not make correspondingly essential changes in the application of the statute of limitations strongly

supports the view that it was not intended by the "unless" clause of Section 43 to introduce a transaction theory of taxation.

(b) Assuming, *arguendo*, that the "unless" clause of Section 43 does allow the results of a transaction to be grouped into a single year notwithstanding that the transaction occurs over a period of years, we think that it is nevertheless not applicable here. The payments which the taxpayer made to its customers in 1936, 1937 and 1938 bore but a tenuous relationship to its income for 1935. To be sure, it is true that but for the fact that sales had been made in the earlier year, there would have been no occasion to make the payments in the later years, but this is hardly sufficient to tie them all together. In no sense were the payments an expense of producing the 1935 income. They were made only to the taxpayer's regular customers. A large number of casual customers, or customers toward whom the taxpayer felt no obligation, were ignored. Payments were not even made to all of those whom the taxpayer had promised to treat fairly. (R. 38.) The payments looked to the future, not to the past.

3. The taxpayer may renew here a contention which it made below, but which may be briefly dismissed. It was argued that $106,604.02 of the taxpayer's gross receipts in 1935 did not constitute income in that year. However, this amount was received as an inseparable part of

the price which was paid to the taxpayer for its goods, and the taxpayer was not under any restriction with respect to its use or disposition. And as both the Board of Tax Appeals and the Court below pointed out (R. 41–43, 63–64), it is well settled that amounts received under such circumstances constitute income in the year of receipt or accrual depending upon the system of accounting which is being used. *North American Oil* v. *Burnet*, 286 U. S. 417; *Brown* v. *Helvering*, 291 U. S. 193.

4. The court below did not err in reviewing the decision of the Board of Tax Appeals (now the Tax Court of the United States). Although *Dobson* v. *Commissioner*, Nos. 44–47, this Term, appears to lay down a salutary rule limiting judicial review of Board decisions in fact cases and thus to disapprove such decisions as *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, and *Bogardus* v. *Commissioner*, 302 U. S. 34, nevertheless such restrictions on review by the circuit courts of appeals can have no application where pure questions of law or statutory construction are involved. For the circuit courts of appeals have appellate jurisdiction in income, estate and gift tax cases from the federal district courts, as well as from the Tax Court. And it would indeed be strange if the content to be given to statutory language (here, Section 43) were to depend upon the fortuitous circumstance of

whether the first case to reach the circuit court of appeals on a particular issue originated in the Tax Court or in a federal district court. Certainly the present controversy could have begun as a suit for refund, if the taxpayer had decided to pay and then seek recovery. It should not be assumed, therefore, in the absence of a clear expression of legislative purpose, that Congress intended to make the meaning of any statutory provision in the tax laws depend upon whether the case that first reached the appellate courts came from the Tax Court or a district court.[9]

That the instant case raises a pure question of law is evident from the fact that the Tax Court rested its decision (R. 44) on this aspect of the case solely upon the authority of its prior decision in *Cannon Valley Milling Co.* v. *Commissioner*, 44 B. T. A. 763, which was affirmed by the Eighth Circuit in 129 F. 2d 642. Moreover, to the extent that a policy favoring administrative finality should control, it was the decision of the Tax Court that upset the determination of the Commissioner

[9] The precise question in this case is one which Congress specifically intended the Circuit Courts of Appeals to review, since the House Report on the Revenue Bill of 1926 expressly states that Circuit Courts of Appeals "upon review may consider, for example, questions as to * * * the proper interpretation and application of the statute or any regulation having the force of law * * *." (Excerpt from H. Rep. No. 1, 69th Cong., 1st Sess., pp. 19–20.) Identical language is also to be found in the Senate Report (S. Rep. No. 52, 69th Cong., 1st Sess., p. 36).

of Internal Revenue which in turn was based upon Treasury Regulations long understood to support his action.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 276

THE SECURITY FLOUR MILLS COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF OF AMICI CURIAE

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STATEMENT

Written consent having been obtained from both parties, this brief is filed pursuant to paragraph 9 of Rule 27 of the Court's rules.

Amici curiae are attorneys for the plaintiff in a suit for refund of income and excess-profits taxes brought by Russell-Miller Milling Co., a Delaware corporation, against Arthur D. Reynolds, Collector of Internal Revenue for the District of Minnesota, now pending for trial as Civil No. 688 in the United States District Court for the District of Minnesota, Fourth Division. At issue is the right of the plaintiff, a miller, to reduce taxable income for taxable years ended August 31, 1935, and August 31, 1936, by the amount of re-

imbursements made by the plaintiff in 1937 to vendees to whom flour had been sold prior to January 6, 1936, at prices which included taxes imposed under Section 9 of the Agricultural Adjustment Act of 1933 (Act of May 12, 1933, c. 25, 48 Stat. 31, 35) in respect of processing of the wheat contained in such flour, such taxes having been impounded in court pending determination of validity of the Act in *United States* v. *Butler*, 297 U. S. 1, and thereafter returned to the plaintiff.[1]

In the petition for certiorari in the pending cause it is pointed out (pp. 12-18) that the question at issue is one of widespread interest in the milling industry, since invalidation of the Act confronted millers generally with the same problem. In confirmation, the following summary statement is made of some of the facts which it is anticipated will be established upon trial of the Russell-Miller case:

On July 9, 1933, the effective date of the processing tax, Russell-Miller increased the selling prices of its flour to reflect such tax; on January 6, 1936, the date of the *Butler* decision, it made corresponding reductions in such prices. During the intervening period a printed form was customarily employed in making flour sales. Beginning May 1, 1935, the form contained a provision reading in part as follows:

> TAXES: The prices named in the contract include the processing taxes as now imposed by the United States on the processing of the commodities used in the manufacture of the products covered by this contract * * *.
>
> Any decrease in the processing taxes as now or hereafter imposed by any legislative or administrative branch of the United States shall inure to the benefit

[1]The plaintiff did not commence doing business until the end of 1935, when a reorganization was consummated whereby the plaintiff took over the property and affairs of a predecessor North Dakota corporation which theretofore had had the same name. However, for brevity the change in corporate entities is disregarded herein, the two companies together being treated as constituting only one corporation.

of the Buyer, if as and when the benefit of such decrease has been actually realized and secured by the Seller, and shall be credited against the contract prices named in this contract to the extent—and only to the extent, that the grain used in the manufacture of the product covered by this contract is milled after the decrease in the processing tax takes effect, and to the extent that the Seller is thereby definitely relieved from the processing tax * * *.

All processing taxes imposed in respect of wheat processed on and before April 30, 1935, were paid to the Collector. Collection of such taxes in respect of wheat processed between May and November, 1935, inclusive, was enjoined by a succession of orders issued by the District Court in proceedings instituted against the Collector. Restraint of collection was conditioned, among other things, upon deposit of the tax in issue in the registry of the court or in banks. The orders provided that in the event invalidity of the tax were established the moneys deposited would be returned to Russell-Miller or, in some of the orders, be disposed of as the court might direct, including "distribution of said moneys * * * pursuant to the plaintiff's offer to make * * * restitution thereof". On March 17, 1936, the deposits, less clerk's fees, were returned to Russell-Miller.

During July, 1933, Russell-Miller set up on its books an account entitled "Tax a/c Processing". At the end of that month and of each succeeding month up to and including December, 1935, it credited the account with the amount of tax imposed in respect of wheat processed during such month. When at the end of the succeeding month the tax became due and was paid, or with respect to May to November, 1935, inclusive, was deposited, the account was debited. When the deposited moneys were returned in March, 1936, the account was credited with the amount received.

In January, 1937, Russell-Miller transmitted a form letter

to each vendee to whom flour processed after April 30, 1935, had been shipped between May 1, 1935, and January 5, 1936, inclusive, in fulfillment of purchases consummated by use of the sales form employed on and after May 1, 1935. Therein reimbursements were proposed on all flour milled, shipped, and delivered between May 1, 1935, and January 5, 1936, inclusive, "covered by bona fide signed contracts carrying the so-called tax clause". Inserted in the letter was a figure representing the "reimbursement due you" on the above basis. With the letter went a form of "Release Agreement", which recited that the reimbursement was "in bona fide settlement" of the written sales agreement or as reimbursement for the amount of processing taxes imposed but not paid, included in such sale prices". Reimbursements were made as proposed and were debited to an account "Processing Tax Reimbursements"; on April 23, 1937, the balance in that account was transferred to "Tax a/c Processing" by debiting the latter and crediting the former.

Though there was doubt until after April 23, 1937, whether Russell-Miller was under legal liability to make reimbursements to vendees, there being then no decisions interpreting the so called "tax clause" used in the form of written sales contract or clauses similar thereto, Russell-Miller as a practical matter at all times regarded itself as under obligation to pay out the returned deposits, and with this in mind it kept the returned deposits set aside in the form of United States Treasury bills until the form letter to vendees was dispatched in January, 1937.

In no twelve-month period ending August 31 in any of the ten years 1930 to 1939, inclusive, did Russell-Miller mill less than 1,906,781 barrels of flour or more than 2,568,[illegible] the average being 2,097,865.6. The number of barrels milled in each of the twelve-month periods ended August 1, 1935, and August 31, 1936, was 1,967,586 and 2,048,472, respective-

ly. Russell-Miller's net income or net loss for its taxable years ended August 31 in each of the years 1930 to 1937, inclusive, for a taxable period of ten months ended June 30, 1938, and for a taxable year ended June 30, 1939, all as finally determined by the Commissioner of Internal Revenue for purposes of Federal income and excess-profits taxes, after eliminating all gains and losses upon the sale or exchange of capital assets, was as follows:

1930	$1,807,831.26
1931	1,687,617.08
1932	457,641.49
1933	827,835.56
1934	1,319,101.87
1935	1,814,508.99
1936	1,100,614.23
1937	($1,168,218.19)[2]
1938	281,415.95
1939	462,372.30

Russell-Miller kept its books and filed its returns on the accrual basis of accounting.

ARGUMENT

Full discussion will no doubt be accorded Section 43 of the Revenue Act of 1934 in the briefs of the contending parties, and on this assumption we content ourselves, so far as this provision is concerned, with a few brief observations.

Neither the prevailing opinion below (*Commissioner* v. *Security Flour Mills Co.* (C. C. A. 10th), 135 F. (2d) 165) nor the dissenting opinion in *Helvering* v. *Cannon Valley Milling Co.* (C. C. A. 8th), 129 F. (2d) 642, suggests that

[2]Russell-Miller's return for 1937 showed a net loss of $321,802.84. While the Commissioner made an audit, no audit-report was issued, presumably because any changes made would not be sufficient to wipe out the loss. To the net loss shown by the return is added $846,415.35, the amount of reimbursements made in 1937 up to April 23, 1937, thus reflecting the Commissioner's contention that the reimbursements are deductible only in the year of payment. The figures for 1935 and 1936 are of course without deduction of either the reimbursements or of the processing taxes deposited during the injunctive period.

the Commissioner's contention secures as clear a reflection of income as does the taxpayer's; indeed, it is quite plain that the opposite is true and that distortion is achieved by the one and avoided by the other. Yet the obvious desirability of clear reflection was sacrificed, in these opinions, in the thought that it was incompatible with the principles of annual tax accounting and that Section 43 was not sufficient to afford relief.

We pass for the moment the point of incompatibility, and consider only the impact of Section 43. The opinions in question do not seek to justify the thrusting aside of Section 43 on the ground that what is said in that provision does not support the taxpayer's position; on the contrary, they give implied if not express acknowledgment—what is in any event manifest—that Section 43, read as written, authorizes the deduction in the taxable year rather than at another time, since otherwise there is distortion rather than clear reflection. Instead they turn from the statute to what the committees of the Congress said about it while in process of enactment. And because they conceive that what is there said is, when read narrowly, inconsistent with what the statute itself provides, they carve the latter to fit the former.

Such procedure is clearly offensive to doctrine both sound and settled. At least in the absence of shocking absurdity or flagrant injustice, search for legislative purpose outside the words of a statute has long been deemed permissible only where there is obscurity or ambiguity. The intent of the lawmaker "is to be sought for primarily in the language used, and where this expresses an intention reasonably intelligible and plain it must be accepted without modification by resort to construction or conjecture." *Thompson* v. *United States*, 246 U. S. 547, 551. See also *Ruggles* v. *Illinois*, 108 U. S. 526, 534. Perusal of committee reports is an aid to interpretation, but it presupposes a need for in-

terpretation; it is admissible only "to solve doubt and not to create it." *Wisconsin R. R. Comm.* v. *C. B. & Q. R. R. Co.*, 257 U. S. 563, 589.

Had enactment of Section 43 been effected without the accompaniment of committee reports, no one would have been troubled as to the meaning of Section 43 or have questioned the unassailability of the taxpayer's position under that provision. The majority below, and it seems also the dissenter in the *Cannon Valley* decision, did not profess to doubt the applicability of Section 43 on the basis of what is therein stated; such doubt as they had arose only when they forgot the statute and began to read the less discriminating language of the reports. They did not resolve doubt by adhering to the rules; they begot doubt by violating the rules.

Even so, one might almost be disposed to indulge the infraction were the committee reports themselves so free from ambiguity as incontrovertibly to establish that the words of the statute, intelligible and sensible as they are both in phraseology and in effect, were patently the result merely of unfortunate selection and that the lawmakers meant something different from what they said. The fact is otherwise, however. True it is—and this is the sole ground upon which the majority opinion below is rested—that the reports mention the making in one year of disbursements relating to several years. But the reference is not given as exclusive or as indicative of the operative limits of the statute, but simply as a statement of the character of problem out of which arose the "necessity" for the provision. There is no reasonable basis for doubting that this is so, but were it otherwise the doubt would be dispelled by what precedes the reference; for there it is said that the provision is merely an extension to new fields of the theory of another provision which, in the case of a loss, authorizes its deduction in a year other than the year in which it was sustained, where necessary to clear

reflection. Manifestly there is no foundation for the argument that Section 43 embraces, not cases involving the shifting of deductions and credits from one year to another, but only cases involving such shifting from one year to two or more other years; certain it is in any event that there is in the committee reports—even were resort thereto permissible—no such unequivocal injunction as to justify maiming the statute.

The majority opinion below seems to assume that the taxpayer's right to prevail is dependent on applicability of Section 43. We think this error, and are of the view that the taxpayer would be entitled to prevail had that provision never been enacted.

In a broad view the issue is one that strikes much deeper than mere interpretation of Section 43. The problem is in the nature of the recurrent one of drawing a line (see *Harrison* v. *Schaffner*, 312 U. S. 579, 583), and involves tracing the division between two principles basic to income-tax law. The one principle relates to the practical necessity, incident to production of a "regular flow of income" (*Burnet* v. *Sanford & B. Co.*, 282 U. S. 359, 365), of measuring taxable income at periodic cut-offs, and the other, equally vital, relates to the like practical necessity of achieving maximum clear reflection of taxable income by the avoidance of distortion. While there are instances where inevitably they impinge on one another, both principles have parts to play, and no reasonable person would contend that either one must always abdicate the field the moment the other appears.

Manifestly a balance of convenience must be struck in the light of the reasonable claims of both principles. In this aspect, we submit, achievement of clear reflection of income should not be sacrificed except as it works substantial inter-

ference with ascertainment and production of revenue on the basis of fixed periods.

In the *Sanford* case, *supra*, there was such interference. In the instant matter the contrary is true. The facts and circumstances in the *Sanford* case are so patently wide of those at bar that they need not be recounted here, and it is presently sufficient to point out only that at issue in this cause is determination of income for the earliest taxable period touched by the facts immediately pertinent to such determination, and there is here no occasion to carry back items either of income or deduction to years whose accounts have been cast up and in respect of which there has intervened the social policy of repose evidenced by the statutes of limitation. Cf. *Elliot Co.* v. *Commissioner*, 45 B. T. A. 82, 87-93. Indeed, so far as interference with periodic ascertainment and production of revenue is concerned, the case is in no essential different from the great mass of controversies which regularly flow through the tribunals to which the Congress has given power of adjudication; like statement may not be made of the *Sanford* case.

Pertinent too in this connection is the character of the adjustment sought to be made. What the taxpayer seeks is for practical and perhaps also for technical purposes the proper reflection of an adjustment in sales price, as distinguished from deduction of a business expense; the provision in the tax clause under which the vendee-reimbursements were made is regarded in the business world simply as an agreement to reduce the price of the article sold (see Paton, Accountants' Handbook, 2nd ed., p. 1124). It would be quite preposterous to say that it constitutes a substantial interference with the orderly administration of the revenue laws to relate the price-refunds to the sales in respect of which they were made, particularly where, as here, they were consummated well within the period given for the assertion of

additional tax claims.[3]

The fact is that every argument the respondent might conceivably advance in refutation of the taxpayer's position in this cause could be made with redoubled persuasion in the case of refunds of so-called excessive profits which war contractors are currently called upon to make to the United States, and they would still fall far short of carrying conviction, by the Treasury's own confession. Such refunds are made without measuring-stick and often without contract; yet as to them the Treasury acknowledges the soundness of the position which the taxpayer here advances. In a letter of September 16, 1941, to the Chairman of the Naval Affairs Investigating Committee of the House of Representatives the Under Secretary said in part (see 423 Commerce Clearing House, par. 6359):

> It is the view of the Department that under the circumstances presented any refunds to the Government resulting from adjustments of such excessive profits serve merely to reduce the original contract price of the materials furnished and the services rendered. Accordingly, in computing income for Federal income tax purposes, the original contract price should be reduced by the amount of any refund of such excessive profits applicable thereto, provided that the original contract is modified in writing so as to indicate the reduced price. The necessary adjustment should be made in the taxable year or years in which the original contract price, with respect to which the refund is applicable, is includible in income. Only the net amount received will therefore be reflected in income.

See opinion of the Comptroller General, No. A-83460.

What has been said serves to emphasize that fundamental-

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[3]Slight must not be lost of the fact that the adjustment here sought relates to isolated, non-recurring transactions. The linking of a price-refund to the sale in respect of which it is made is ordinarily not of significance, from the standpoint of clear reflection of income, if it falls into the category of the usual year-end transactions which every business regularly experiences; clear reflection is achieved by consistent treatment year after year. Quite different is the result when the transaction, as at bar, is altogether extraordinary.

ly the dispute is over proper accounting. As such it is of a class with that involved in *Dobson* v. *Commissioner*, October Term 1943, No. 44, decided December 20, 1943; indeed, it is even more clearly an accounting problem than was that in the *Dobson* case. Such a problem, as the *Dobson* decision points out, is a fact-problem "for the Tax Court to determine." The Tax Court has made such determination in this case (*Security Flour Mills Co.* v. *Commissioner*, 45 B. T. A. 671), concluding (p. 681), following what it had already done in *Cannon Valley Milling Co.* v. *Commissioner*, 44 B. T. A. 763, "that the payments made to the vendees should be allowed as a deduction in computing the taxpayer's income for 1935, since they related to the sales made in that year and did not relate to the sales made in the later period." As was true in the *Dobson* case, so here "There is no statute law to the contrary". And since there is plainly "a rational basis" for the conclusion reached by the Tax Court, there was at bar no pervading error of law upon which the Circuit Court of Appeals could base a reversal. Accordingly, the Tax Court's decision should stand.[4]

Respectfully submitted,

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[4]Though obiter, the Tax Court said (p. 679) that the taxpayer was not "legally obligated" to reimburse its customers. There is doubt as to the correctness of the decisions cited in support of this statement. See **Smith v. Sparks Milling Co.**, 219 Ind. 576, 39 N. E. (2d) 125, a soundly-reasoned decision.

P. 2.

SUPREME COURT OF THE UNITED STATES.

No. 276.—October Term, 1943.

The Security Flour Mills Company, Petitioner, *vs.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit.

[February 28, 1944.]

Mr. Justice Roberts delivered the opinion of the Court.

The Circuit Court of Appeals has held[1] that the Board of Tax Appeals erred in deciding[2] that the petitioner was entitled, in reporting its income tax for the year 1935, to deduct payments made by it in 1936, 1937, and 1938. Because of a conflict of decision[3] we granted certiorari.

The petitioner, which conducts a flour mill, reports its net income on the accrual basis. As a first domestic processor of wheat it was subject to the processing tax levied under the Agricultural Adjustment Act of 1933. In the early months of 1935 it paid processing taxes, and claimed, and was allowed, the amount so paid as a deduction from gross income in its federal income tax return for 1935. The amount thus paid is not involved.

Petitioner instituted a suit to enjoin the collection of processing taxes, and obtained a temporary injunction enjoining further collection on the condition that *pendente lite* it file information returns and pay the amount of the tax into a depository. From May 1 to December 31, 1935 petitioner so paid $93,000 and accrued over $9,000 additional upon its books for processing tax for the last month. It also accrued about $1,000 as a reserve for possible increases in taxes earlier paid. On January 6, 1936, the taxing provisions of the Agricultural Adjustment Act were held unconstitutional by this court. Certain of the petitioner's vendees attempted to intervene in the injunction suit and to have impounded moneys returned to them. Petitioner resisted and the court denied

[1] 135 F. 2d 165.
[2] 45 B. T. A. 671.
[3] Helvering v. Cannon Valley Milling Co., 129 F. 2d 642.

the intervention and made an order directing the depository to pay to the petitioner the impounded money, which was done February 28, 1936.

The petitioner set up on its books a suspense account covering the items above mentioned under the title "Reserve for Processing Tax, Claims, etc." The petitioner refunded various sums to its customers, totaling over $45,000 in 1936, 1937, and 1938 to reimburse customers for processing tax included in the sales price of flour sold them in 1935 and not paid to the Collector of Internal Revenue as processing taxes. In its 1935 tax return petitioner deducted from gross income the total of the amounts impounded and accrued but not paid the Collector in the year 1935 as accrued tax liability. The Commissioner found a deficiency by disallowing the petitioner's deduction for taxes accrued but not paid in 1935.

The propriety of the claimed deduction depends upon the construction of Sections 23(a), 41 and 43 of the Revenue Act of 1936.[4] Section 23 permits the deduction of ordinary and necessary expenses "paid or incurred during the taxable year in carrying on any trade or business". Section 41 declares the general rule that the taxpayer's annual accounting period shall be the fiscal year or calendar year, depending upon the method of accounting regularly employed, provided such method clearly reflects income. Section 43, on which the petitioner relies, provides:

"The deductions and credits provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." . . .

It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent, and this principle is fully applicable to a tax liability for which the taxpayer denies, and payment whereof he is contesting.[5] Here the petitioner, in figuring its costs and its sales price to consumers, added the amount of the processing tax, but it collected its purchase price as such and designated no

[4] c. 277, 48 Stat. 680, 688, 694.

[5] See Dixie Pine Products Co. v. Commissioner, No. 84, Oct. Term, 1943, where this rule of law was reaffirmed and applied by the Board of Tax Appeals, the Fifth Circuit Court of Appeals, and by this court, and cases cited.

part of it as representing the tax. The petitioner received the purchase price as such. Its tax liability, if any, to the United States did not differ from other debts. Since it denied liability for, and failed to pay, the tax during the taxable year 1935, it was not in a position in its tax accounting to treat the Government's claim as an accrued liability. As it admittedly received the money in question in 1935 and could not deduct from gross income an accrued liability to offset it, the receipt, it would seem, must constitute income for that year.

Petitioner nevertheless insists that Section 43 of the Revenue Act, which requires that deductions be taken for the taxable year in which the amount was paid or accrued, creates an exception applicable to this case by its concluding clause, "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust or unfair not to isolate the transaction and treat it on the basis of the long term result. We think the position is not maintainable.

The Revenue Act of 1921, in Sections 214(a)(6) and 234(a)(4)[6] authorized the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, that was necessary clearly to reflect income. The qualifying clause of Section 43 was first added as Section 200(d) of the Revenue Act of 1924.[7] The reports of both House and Senate Committees concerning this change said:

"The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should."[8]

From these reports it is clear that the purpose of inserting the qualifying clause was to take care of fixed liabilities payable in

[6] c. 136, 42 Stat. 227, 240, 255.

[7] 43 Stat. 253, 254.

[8] H. R. 179, 68th Cong., 1st Sess., pp. 10, 11; S. R. No. 398, 68th Cong., 1st Sess., pp. 10, 11.

fixed installments over a series of years. For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year. But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.

The question is not whether the Board, within its discretion, made a determination of fact. Compare *Dobson* v. *Helvering*, 320 U. S. —.) It is rather whether, as matter of law, the Board misconstrued the extent of the power conferred by the Revenue Act.

"All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt."[9]

The rationale of the system is this: "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."[10]

This legal principle has often been stated and applied.[11] The uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying

[9] Burnet v. Sanford & Brooks Co., 282 U. S. 359, 363.

[10] *Id.*, p. 365.

[11] See e. g. Lucas v. Ox Fibre Brush Co., 281 U. S. 115, 120; Burnet v. Thompson Oil & Gas Co., 283 U. S. 301, 306; Woolford Realty Co. v. Rose, 286 U. S. 319, 326; Tait v. Western Maryland Ry. Co., 289 U. S. 620, 624; Brown v. Helvering, 291 U. S. 193; Guaranty Trust Co. v. Commissioner, 303 U. S. 493, 498.

the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.[12]

But the petitioner urges that Section 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a given year, but, in the light of ultimate gain from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year. The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation.

As we said in *Dixie Pine Products Co.* v. *Commissioner*, *supra*, referring to a section identical with Section 43 now under consideration, "The provisions of the Revenue Act of 1936 worked no significant change over earlier Acts respecting the permissible basis of calculating annual taxable income."

We are of opinion that the purpose of the language which Congress used was not to substitute, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system.

The judgment is affirmed.

Mr. Justice DOUGLAS and Mr. Justice JACKSON are of opinion that the case is governed by *Dobson* v. *Helvering*, 320 U. S. —, and that the judgment should, for the reasons therein stated, be reversed.

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[12] See the cases cited Notes 5, 9 and 11.